Dipartimento del Tesoro

Relevant Factors Influencing Public Debt Developments in Italy

May 2019

Ministero dell'Economia e delle Finanze

INDEX

EXECUTIVE SUMMARY

- Italy's public finances improved in 2018, as the general government deficit declined to 2.1 percent of GDP, from 2.4 percent in 2017. The debt-to-GDP ratio rose to 132.2 percent, from 131.4 percent in 2017, but this was partly due to a planned increase in the year-end liquidity position of the government worth more than 0.3 percent of GDP. Furthermore, 2017 and 2018 debt levels were revised up by 0.2 percentage points of GDP due to changes in the statistical definition of the public sector.
- The primary budget balance of the general government (that is, the balance excluding interest payments) in 2018 posted a 1.6-percent-of-GDP surplus, up from 1.4 percent in the two previous years. Italy has recorded a primary surplus in all but one of the twenty years since the start of the European Monetary Union.
- However, owing to a still-high differential between the average borrowing cost and the nominal GDP growth rate, as well as adverse stock-flow adjustments, Italy in 2018 did not fulfill the debt-reduction criterion in any of the three configurations envisaged in the 'Six Pack' and in its national transposition (Law 243, December 2012).
- In accordance with Article 126(3) of the TFEU, whenever a member state appears to have exceeded the reference values, the European Commission is expected to prepare a report identifying "all other relevant factors" that should be considered when assessing compliance with the Debt rule.
- At the request of the Commission, with the present report the Italian government is submitting a series of factors Italy believes to be "relevant in order to comprehensively assess in qualitative terms the excess (of the debt ratio) over the reference value."
- The first relevant factor discussed in this report concerns the macroeconomic context. Deficit and debt ratios in 2018 were once again boosted by lower-than-expected nominal GDP growth. The downturn in Italy's manufacturing activity and renewed deflationary pressures were primarily caused by external factors. Global trade and investment slowed markedly, affecting in particular manufacturing and export-oriented economies like Germany and Italy.
- Italy's nominal GDP in 2018 grew by 1.7 percent, way below the 2.9 percent increase projected in the Stability Program 2018 (SP2018). The GDP deflator advanced by only 0.8 percent. If it had risen by 1.3 percent, as projected in the SP2018, the debt ratio net of changes in the government's liquidity position would have declined by 0.2 percentage points compared to 2017. If real GDP growth had also been in line with the SP2018, the debt ratio would have declined by 1.1 points.
- The second factor concerns *ex post* compliance with the preventive arm of the Stability and Growth Pact (SGP). According to government estimates, last year the structural budget balance recorded a 1.4 percent-of-GDP deficit, unchanged from 2017. The previous government had committed to a 0.3 percentage point improvement in the structural balance. The miss is partly due to an *ex post* downward revision in the output gap due to the lowering of growth projections for the entire

2018-2022 period and to an increase in capital contributions. The new government fulfilled existing commitments by refraining from any fiscal policy easing in 2018 even as cyclical indicators suddenly worsened in the second half of the year.

- Looking forward, the third factor is Italy's commitment to fiscal consolidation and to reducing the debt-to-GDP ratio over the coming years. The recently unveiled Stability Program 2019 (SP2019) revised up the general government deficit forecast for this year from 2.0 to 2.4 percent of GDP due to worsening economic prospects: the 2019 real GDP growth forecast has been lowered to 0.2 percent from 1.0 percent in the final version of the 2019 Budget.
- However, updated estimates suggest that the structural balance in 2019 will perform better than the Commission's latest projections. Indeed, data on budget execution and the takeup of new welfare policies suggest that even the government's deficit projections could be outperformed. Given the 0.18 percentage points of flexibility for infrastructure investment and geological-risk mitigation granted by the Commission, the change in the structural balance would not represent a significant deviation.
- The government is targeting a decline in the budget deficit to 2.1 percent of GDP in 2020, 1.8 percent in 2021 and 1.5 percent in 2022. The structural balance will improve by 0.2 percentage points in 2020 and 0.3 points in both 2021 and 2022. The structural deficit in the final year of the program will decline to 0.8 percent of GDP, on the way to a zero balance over the following two to three years.
- Safeguard clauses involving indirect tax hikes in 2020 and 2021 play an important role in budget projections for the coming years, as they are included in the existing legislation (2019 Budget). With the motion that approved the SP2019, the Italian Parliament formally endorsed the deficit targets contained therein. The Commission's projection for Italy's 2020 deficit completely excludes the safeguard clauses. That is tantamount to stating that the deficit will be 1.3 percent-of-GDP higher than the official target, whereas Parliament only called for alternative funding measures.
- The present report also revisits and updates arguments that were already put forth in previous editions. The most relevant one concerns the quantification of the output gap. Country-specific technical changes were endorsed last year by the Output Gap Working Group and adopted by the Commission. Even so, the Spring Forecast 2019 features estimates of Italy's output gap ranging between -0.1 and -0.3 percent in 2018-2020. These estimates look totally at odds with macroeconomic evidence not only on a comparative basis (Italy in 2020 would have the same output gap as Germany), but also in view of relatively high unemployment and ultra-low inflation.
- The commonly agreed methodology for estimating potential output suffers from several shortcomings. However, we show that, with minor modifications to the NAWRU anchor and TFP priors, even this methodology would yield significantly wider output gap estimates of close to -2.0 percentage points for the 2019-2022 period.
- A wider output gap would have important implications for compliance with the preventive arm of the SGP. For instance, the Italian economy this year would be in 'bad times' (output gap wider than -1.5 percentage points, which lowers the required fiscal adjustment from 0.6 to 0.25 points when growth is below potential); given the Commission deficit estimate, the structural balance, would be -1.6 percent of GDP instead of -2.4 percent, a sizable difference in terms of required adjustment towards

the Medium-Term Objective. With wider output gap estimates, Italy would have also been closer to satisfying the debt rule in the cyclically-adjusted configuration.

- A further relevant factor is that in 2019-2022 Italy will devote significant fiscal resources to improving social inclusion and revitalizing public investment. The Joint Employment Report, the Country Report and the CSRs urged Italy to improve social inclusion, in particular by promoting an increase in the employment rate via a reform of Active labor market policies (ALMPs), raising labor market participation of women and rationalizing family-support measures.
- The recently enacted Citizenship Income policy responds to these recommendations, as it involves a significant increase in income support for individuals and households below the poverty line and in addition earmarks additional human, financial and technological resources for Job Centers and other ALMPs, including training.
- The CSRs 2018 also urged Italy to foster research, innovation, digital skills and infrastructure through better targeted investment and increased participation in vocational-oriented tertiary education. The SP2019 aims to raise public investment by 0.6 percentage points of GDP by 2021 compared to the 2018 outturn (2.1 percent of GDP). In addition, resources for education and research have been increased and the National Reform Program targets many areas covered by the CSRs.
- Another relevant factor is debt sustainability. The government believes that the policy course charted in the SP2019 will enhance the supply side of the economy (via increased public investment and labor-market participation, as well as greater incentives to private investment and hiring) and support aggregate demand, thereby leading to faster real GDP growth. The scenario analysis presented in the SP2019 shows that, provided the program is fully implemented, the debt-to-GDP ratio would significantly decline over the next ten years under most conceivable scenarios.
- Furthermore, using the national scenario for age-related expenditures (which relies on Istat demographic projections), the long-term fiscal sustainability indicators continue to point to low long-term risks.
- Another aspect to consider is contingent liabilities. According to Eurostat figures, Italy has one of the lowest levels of government guarantees in the EU. The latest data are for 2016, but even with the guarantees provided as part of the banking sector interventions in 2017, the contingent liabilities of Italy’s general government remain low on a comparative basis.
- Finally, Italy’s overall financial position is strong. The recent rise in government bond yields looks manageable thanks to Italy’s long-dated and fixed-rate debt composition. In addition, private sector debt is low, especially household debt. Property prices have not yet bottomed out after a sharp drop in 2011-2014. Banks have raised capital and drastically reduced their NPL ratios. Banking sector profitability has been restored and systemically-relevant institutions comfortably passed the EBA stress tests. The current account of the balance of payments remains in surplus (2.5 percent of GDP in 2018) and the net international investment position is close to balance.

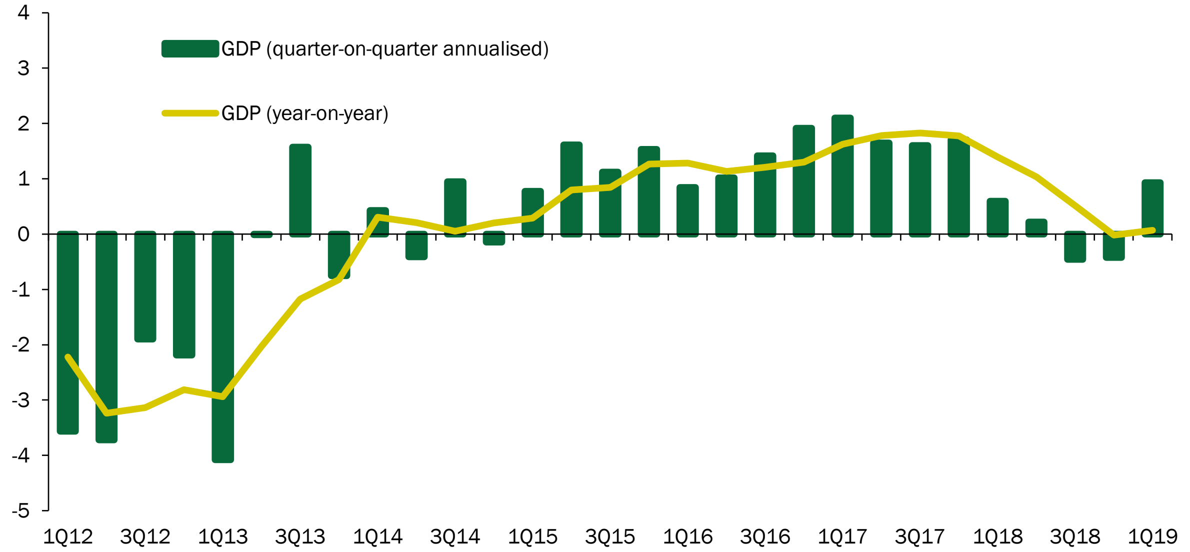
I. MACROECONOMIC CONTEXT

I.1 CYCLICAL DEVELOPMENTS

Real GDP growth returned into positive territory in the first quarter of this year following a marked slowdown in the first half of 2018 and a slight contraction in the two final quarters. According to the flash estimate from Istat, real GDP rose by 0.23 percent quarter-on-quarter, with manufacturing, construction and services posting output gains as final demand remained weak while inventories and net exports provided a positive contribution.

As highlighted in the recent Stability Program, US-China trade disputes and geopolitical risks remain the main downside risks for the Italian economy. In 2018 industrial activity was also negatively affected by the drop in auto sales, which hurt Italian producers directly and via the value chain of German carmakers.

FIGURE I.1: ITALY'S REAL GDP GROWTH

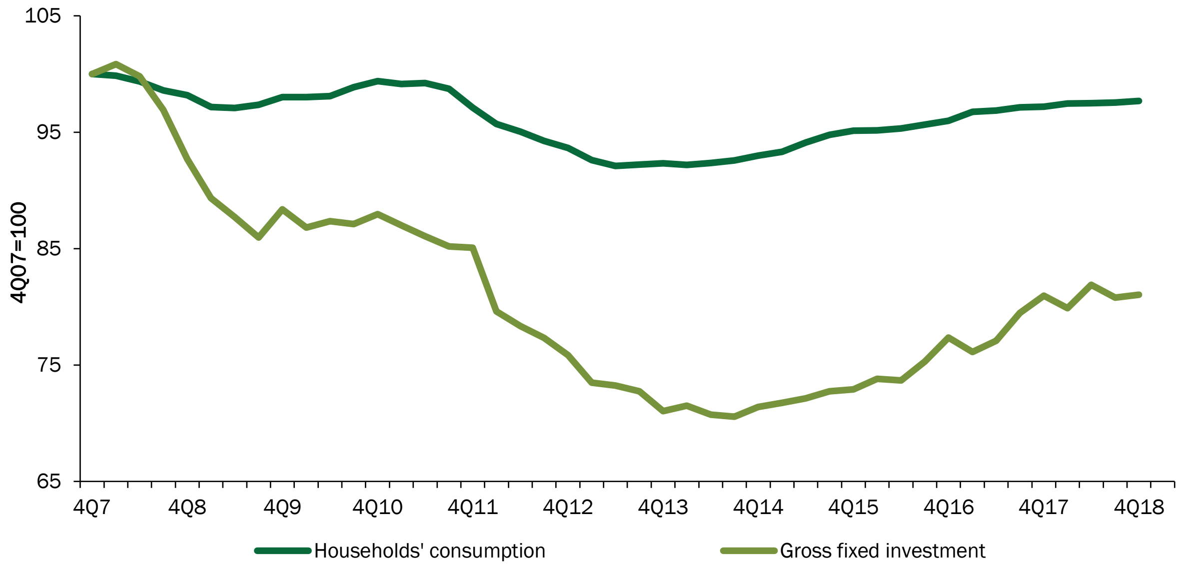


Source: ISTAT.

The latest cyclical indicators point to a continuation of slightly positive growth in the second quarter. The manufacturing PMI is still below the expansion threshold (i.e. 50.0) while services have been registering modest increases in business activity over the last three months after a slight dip in January. In line with the PMIs, the Istat business surveys suggest that the near term outlook for manufacturing, though improving slightly in May, remains challenging, while companies operating in construction and services are more optimistic.

Domestic demand (investments and households' consumption expenditure) is still below pre-crisis levels. Uncertainty and weakness in new orders have led firms to revise down their investment plans, while consumers remain cautious and the saving propensity has risen.

FIGURE I.2: HOUSEHOLDS CONSUMPTION AND GROSS FIXED INVESTMENT (4Q07=100)



Source: ISTAT.

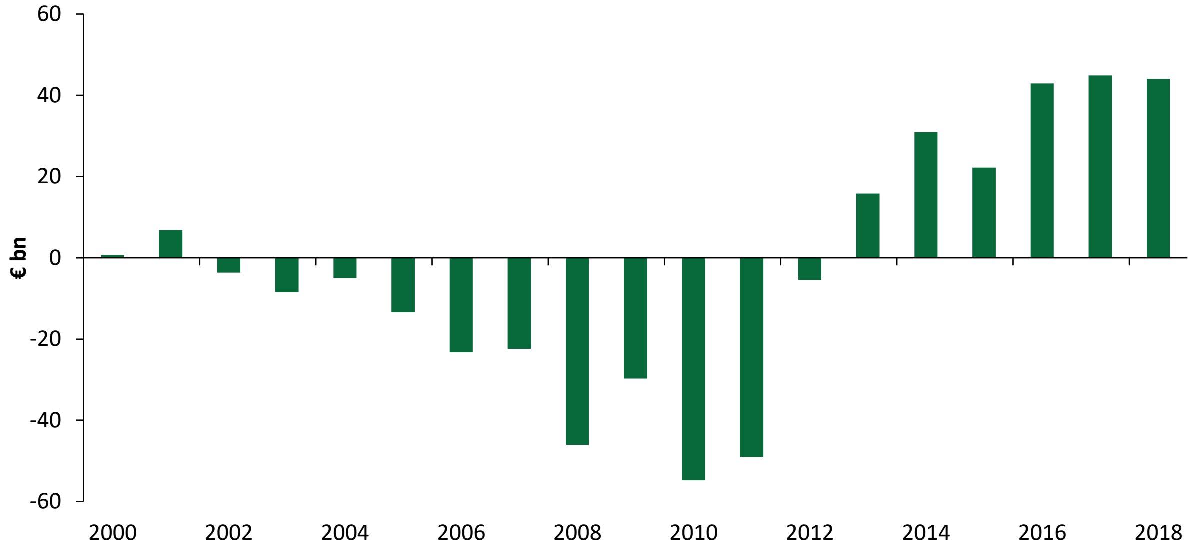
In addition, Italy's export sector was affected by the downturn in world trade. According to national accounts statistics, Italy's exports increased by less than 2 per cent in 2018, showing a more pronounced moderation than other European partners. Looking at the sectoral performance, compared to 2017, pharmaceuticals and transportation equipment, notably autos, showed the most pronounced contraction.

Italy's current account surplus in 2018 decreased slightly, to 2.5 percent of GDP from 2.7 percent in 2017. Recent months have seen a renewed improvement: in the twelve months ending in March the current account surplus amounted to 46.9 billion (2.7 percent of GDP), from 45.3 billion in the corresponding period of 2018. The increase was due to the improvement of the balances in services and primary income (respectively equal to 18.6 billion from 11.2 and to -2.7 billion from -5.0), partly offset by a slight reduction in the goods surplus (48.3 billion, from 54.7) and a higher deficit in secondary income (-17.3 billion, from -15.6).

Italy's net international investment position has improved by about 20 percentage points of GDP over the last five years. At the end of 2018 it stood at -69 billion (-3.9 percent of GDP) after touching a low of -52.4 billion in the previous quarter.

The improvement in Italy's external position is partly due to a persistent slack in the economy. In fact, Italy continues to experience lower inflation and higher unemployment than the Euro area average.

FIGURE I.3: CURRENT ACCOUNT (€ BN)



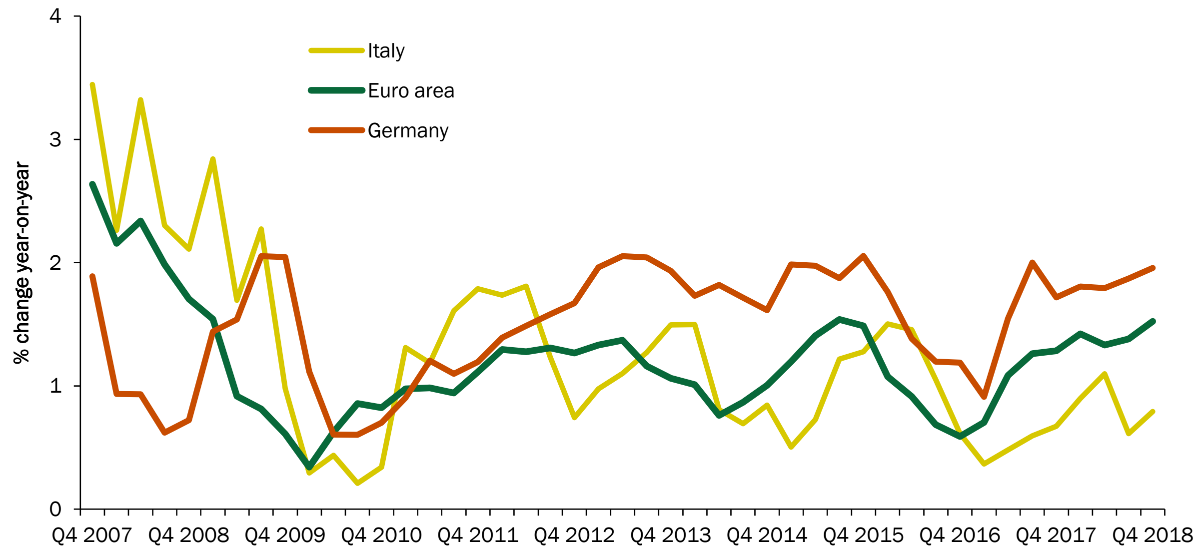
Source: Bank of Italy.

I.2 TRENDS IN INFLATION AND GDP DEFLATOR

Weakness in nominal GDP growth remains the key obstacle to a significant improvement in the deficit and debt ratios. Last year the GDP deflator came in well below the Stability Program forecast (0.8 vs 1.3 percent), with a gap of 0.6 percentage points vis-à-vis the Euro area and 0.9 points versus Germany.

The rate of growth in the deflator was higher than in 2017 (0.5 percent), but this was mostly due to a wage hike in the public sector. As a result of the slowdown in real growth, in 2018 nominal GDP growth slowed to 1.7 percent, from 2.2 percent in 2017.

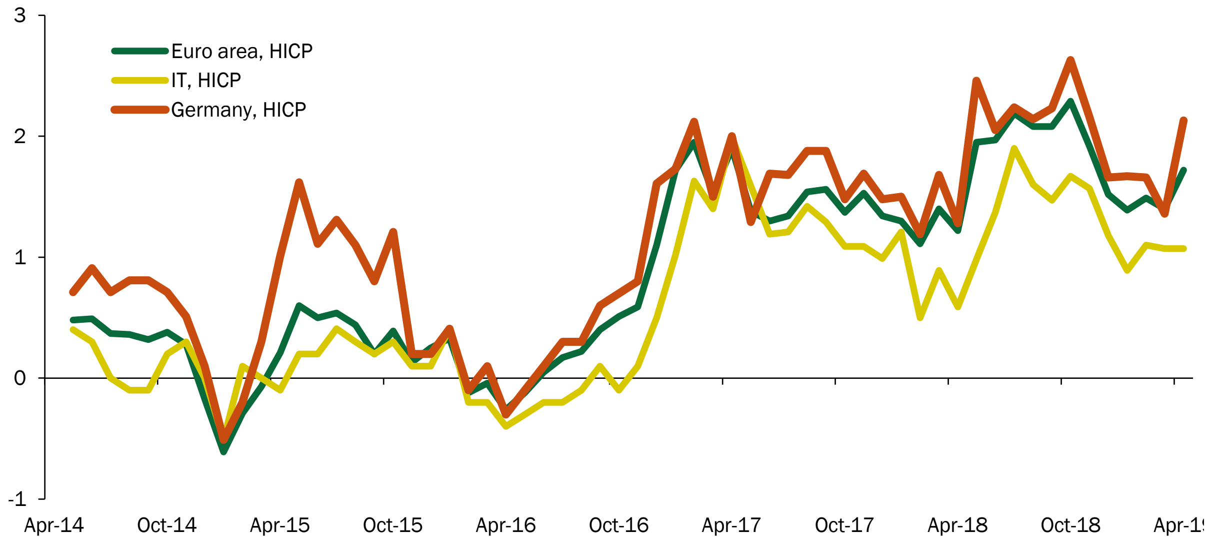
FIGURE I.4: GDP DEFLATOR GROWTH, % CHANGE Y-O-Y



Source: Thomson Reuters Datastream.

Harmonised inflation in 2018 in Italy remained lower than in the rest of Europe and prospects for the current year do not point to significant improvements: the April inflation reading was 1.1 percent for the HICP and 0.7 percent for the core HICP, compared to 1.7 percent and 1.4 percent, respectively, for the Euro area.

FIGURE I.5: HARMONISED INDICES OF CONSUMER PRICES (ALL ITEMS, 2015=100), PERCENT CHANGE Y-O-Y



Source: EUROSTAT.

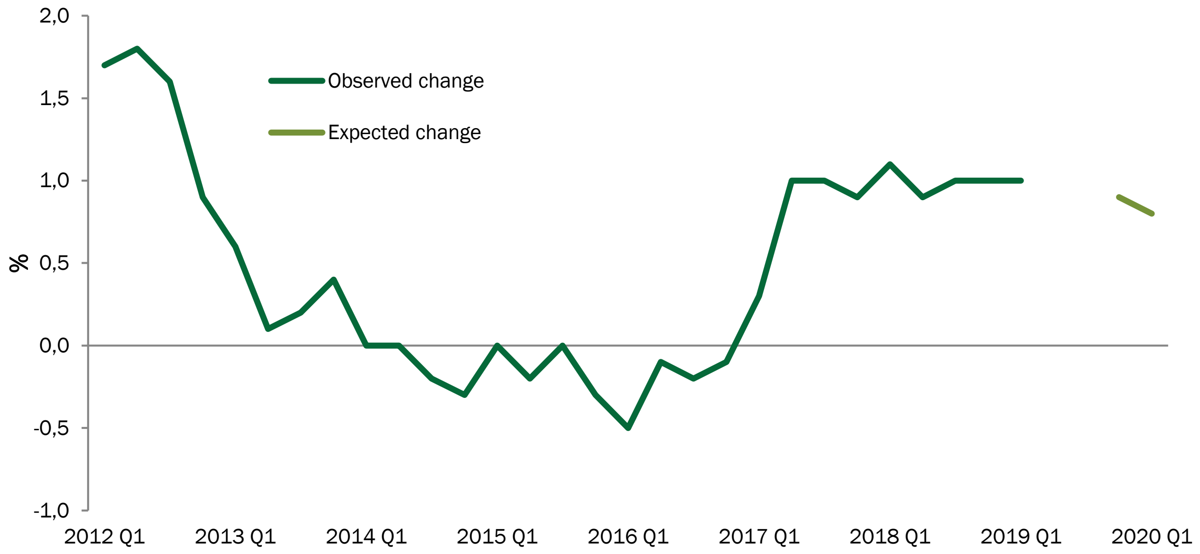
Looking forward, according to the latest survey released by the Bank of Italy, firms lowered their inflation expectations across all time horizons[1]. Similar indications emerge from Istat surveys: on average in the first quarter the balance between the share of manufacturing firms expecting to raise their prices and the share of those planning to reduce them narrowed. As for consumers, the share of those expecting prices to remain unchanged or decline over the next twelve months increased slightly compared with the last quarter of 2018 (reaching 56.4 per cent). Since the end of last year inflation expectations for 2019 of professional forecasters have declined to 0.9 per cent in April, 0.4 percentage points below the projections for the euro area as a whole[2].

Weakness in domestic demand is the key factor driving Italy's negative inflation differential vis-à-vis the rest of the Euro area. The latest Eurostat data (for March 2019) show an unemployment rate of 10.2 percent in Italy and 7.7 percent in the Euro area, while Germany's rate hit new lows in recent months, reaching 3.2 percent.

Even though labour market conditions have improved sharply since 2014, the excess supply of labour continues to bear down on wages. Furthermore increased reliance on fixed term contracts contributed to hold down wage growth especially in the private sector. In the public sector, contractual wages rose markedly in 2018, due to the implementation of a new contract and arrears payments after ten years of nominal wage stability. In the private sector, however, growth in contractual wages remains quite low (0.8 percent year-on-year in March 2019).

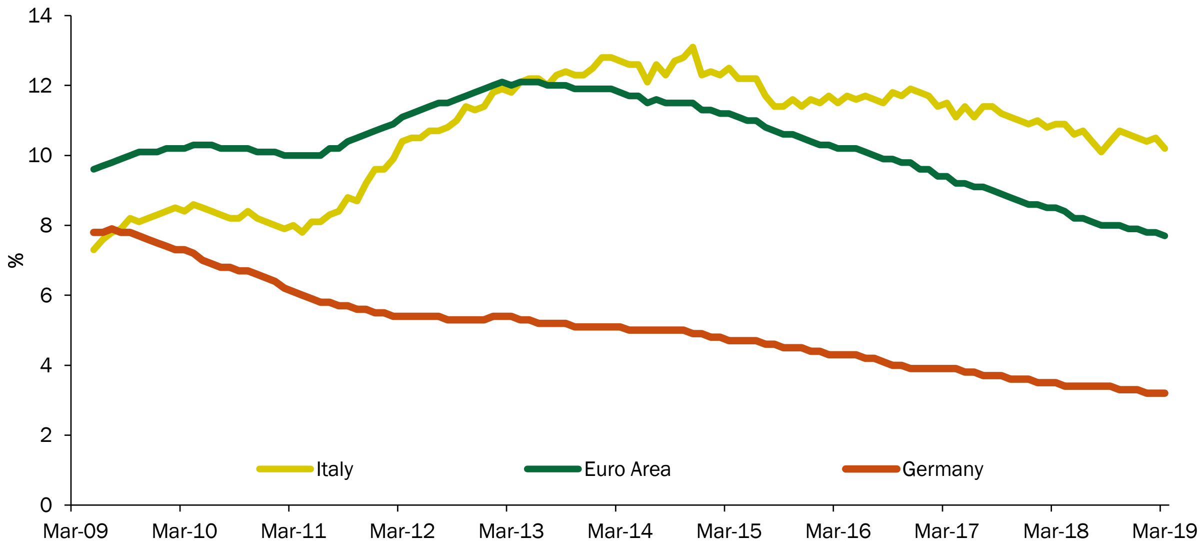
[1] Economic Bulletin, Bank of Italy, April 2019.
[2] Consensus Economics, Consensus Forecast May 2019.

FIGURE I.6: CHANGES IN FIRMS' OWN SALES PRICES:ACTUAL AND FORECAST BY FIRMS



Source: Bank of Italy, Economic Bullettin, April 2019.

FIGURE I.7: UNEMPLOYMENT RATES (AS A PERCENTAGE OF LABOUR FORCE)



Source: EUROSTAT.

II. RECENT BUDGET AND DEBT PERFORMANCE

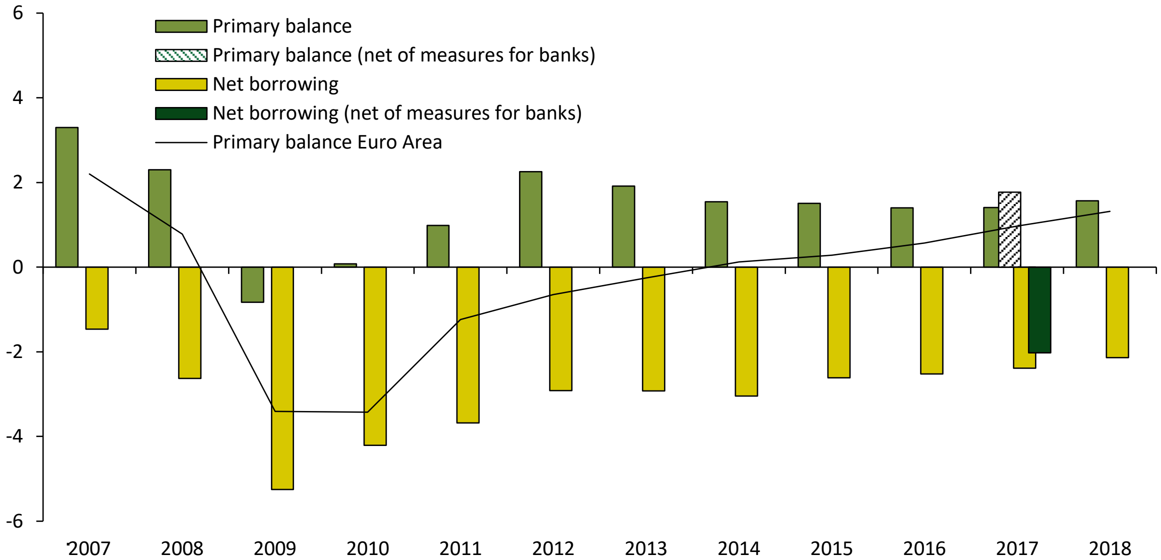
II.1 DEFICIT AND DEBT DEVELOPMENTS IN 2018

The general government budget deficit declined to 2.1 percent of GDP in 2018, from 2.4 percent in 2017. Deficit-reducing measures, including a tight control over public spending, ensured a further decline in the general government deficit, which has shown consecutive reductions since 2014.

The decline in net borrowing in 2018 was due to an increase in the primary surplus to 1.6 percent of GDP, from 1.4 percent in the previous year, and to 0.1 percentage point decline in the interest burden.

The broadening of the general government definition[3] left the level of net borrowing and the ratios to GDP in 2017 and 2018 roughly unchanged.

FIGURE II.1: GENERAL GOVERNMENT DEFICIT AND PRIMARY BALANCE, EDP (% of GDP)

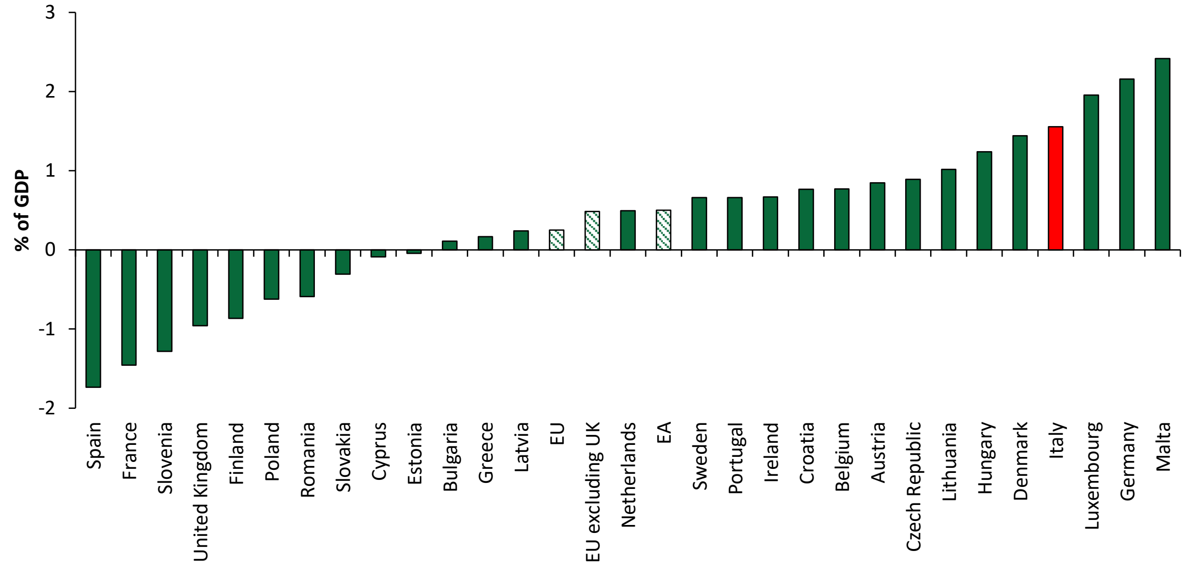


Source: ISTAT and EUROSTAT database.

Since the economic and financial crisis, fiscal consolidation has been a central feature of Italy's economic policy and the decline in net borrowing has been ensured by the maintenance of positive primary balances: Italy has recorded one of the highest primary surpluses in the Euro Area and the European Union over the last six years (about 1.6 percent of GDP, as shown in Fig. II.2). In the 2013-2018 period, both the Euro Area and the European Union recorded a primary surplus of less than 0.5 percent of GDP.

[3] The units reclassified within the general government sector are: Italian rail network (RFI SpA); FerrovieNord SpA; National agency for investment attraction and enterprise development (Invitalia); Cassa del Trentino SpA; Financial institution for the development of Lombardia SpA; Regional financial institution of Abruzzo SpA; Finpiemonte SpA; Regional financial institution of Valle d'Aosta SpA; Acquirente Unico SpA; Institute for research on energy system SpA.

FIGURE II.2: GENERAL GOVERNMENT PRIMARY BALANCE, EDP (average 2013-2018)



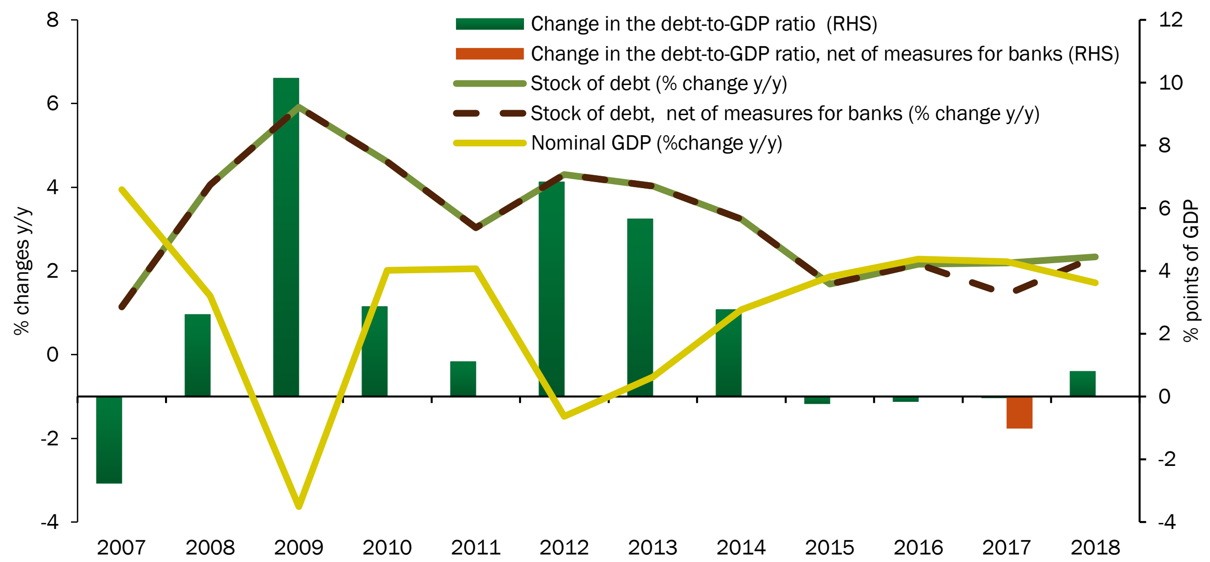
Source: AMECO database.

The 2019 Commission Spring Forecast projects the Italian primary surplus to decline to 1.2 percent of GDP in 2019. Nonetheless, the forecast confirms the soundness of Italy's position vis-à-vis other European partners with a high level of debt-to-GDP ratio and similar economic growth prospects. The primary balance in the Euro Area is forecast below 0.9 percent in 2019. In 2020 Italy's primary surplus is projected to drop to 0.2 percent of GDP as the Commission forecast does not consider the deficit-reducing effects of the 2020 VAT hike envisaged by the 2019 Budget.

The attainment of a significant primary surplus has contributed to the stabilisation of the debt-to-GDP ratio in recent yeas. Following the statistical revisions to the GDP level and the broadening of general government definition made by ISTAT in agreement with Eurostat[4], and those on the debt stock by the Bank of Italy, the debt ratio stood at 131.4 percent in 2016 and 2017. The figure for 2016 is unchanged from the previous estimate, while the 2017 figure was revised up from the previous 131.2 percent of GDP. Net of the change in the public sector definition, in 2017 the ratio-to-GDP would have declined by 0.3 percentage point. Also, net of the whole impact of interventions in support of the banking system, the ratio to GDP would have declined by a further percentage point (see Fig. II.3).

[4] The upward revision of public debt stock following the widening of general government perimeter is about 800 million in 2016, more than 5.6 billion in 2017 and 5.9 billion in 2018.

FIGURE II.3: KEY DRIVERS OF GENERAL GOVERNMENT DEBT, EDP (% changes y/y and % points of GDP)



Source: ISTAT.

In 2018, the ratio of public debt to GDP rose by 0.8 percentage points. The preliminary figure of 132.2 percent is higher than the target of 131.7 percent projected in the Update of macroeconomic and budgetary forecasts of December 2018 due to lower-than-expected nominal GDP growth of 1.7 percent compared to 2.1 percent projected in December 2018.

The increase in the debt ratio in 2018 compared to 2017 was mainly due to: i) the increase in the borrowing requirement; ii) an increase of Treasury year-end liquid balances worth more than 0.3 percent of GDP; iii) issuance premia and the the revaluation effect of inflation-linked securities, worth 0.4 percent of GDP.

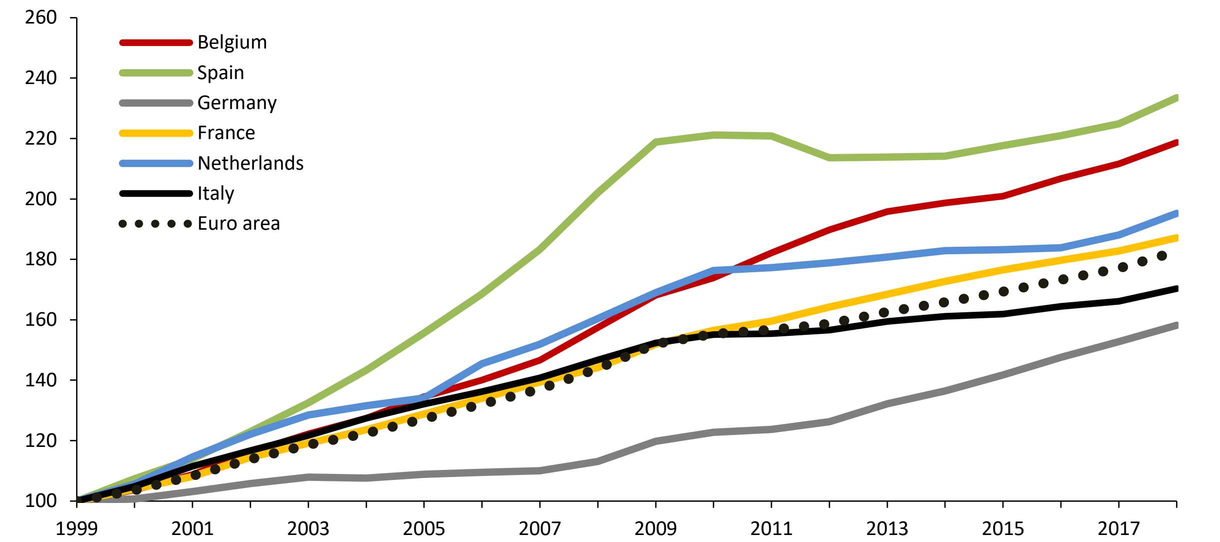
The rise in the primary surplus mitigated the overall effect of the snow-ball component (the difference between the average cost of funding and nominal growth).

The corrective arm of the SGP explicitly mentions the development of primary expenditure as a relevant factor to be considered for the purpose of the Excessive Deficit Procedure (Art. 3, of Regulation 1467/1997). As already stressed in previous Reports on relevant factors, the soundness of Italy's primary surplus was supported by the stabilisation of primary expenditure, and especially of current noninterest expenditure.

General government current expenditure excluding interest declined from 41.7 percent of GDP in 2016 to 41.2 percent in 2017. In 2018 it rose to 41.6 percent due to a rise in public sector compensation, social transfers and other current expenditures. Nonetheless, the increase in the wage bill as a share of GDP was partly temporary because the new public-sector labour contract covered three years ending in 2018 and, as a result, involved the payment of arrears.

Growth in Italy's public sector compensation has been extremely muted, compared to both past trends and other Euro area countries, as a result of extreme wage moderation and a decline in payrolls. In 2018 compensation rose by 3.1 percent, for the reasons mentioned above. Even so, with public sector employment still declining and only minor adjustments in nominal wages and salaries, the ratio of compensation to GDP is set to resume falling in 2019. On a comparative basis, its share of GDP is only higher than Germany's.

FIGURE II.4: GENERAL GOVERNMENT PRIMARY CURRENT SPENDING (level, 1999= 100)



Source: Elaboration on AMECO data.

TABLE II.1: COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (euro bn)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
France	268,5	273,1	278,5	281,3	284,0	290,8	294,1	296,8	301,9
Germany	212,3	217,8	224,4	229,8	237,8	246,7	256,3	267,0	277,3
Italy	166,1	164,8	163,5	162,1	164,1	166,7	171,8	172,6	174,0
Spain	113,9	114,7	115,2	119,4	121,5	123,0	127,0	131,5	136,3

Source: AMECO. For 2019-2020 EC 2019 Spring Forecast, for Italy projections based on unchanged legislation of EFD 2019.

TABLE II.2: COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (% GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
France	12.9	12.9	13.0	12.8	12.7	12.7	12.5	12.3	12.2
Germany	7.7	7.7	7.6	7.5	7.5	7.5	7.6	7.7	7.7
Italy	10.3	10.3	10.1	9.8	9.7	9.6	9.8	9.7	9.5
Spain	11.0	11.2	11.1	11.0	10.9	10.5	10.5	10.5	10.5
EU28	10.5	10.5	10.4	10.2	10.2	10.1	10.1	10.1	10.0

Source: AMECO. For 2019-2020 EC 2019 Spring Forecast, for Italy projections under unchanged legislation (Stability Program 2019)

Public investment in 2018 did not increase as planned while a better outcome is expected for the current year; in fact, preliminary estimates point to a 5.2 percent increase. The 2019 Budget addressed a total amount of €43.6 billion to the fund in the period 2019-2033 to provide new stimulus to public investment. The new policy scenario in the Stability Program aims to further reinforce public investment in order to bring capital accumulation back towards pre-crisis levels.

II.2 COMPLIANCE WITH THE STABILITY AND GROWTH PACT

Concluding the European Semester, in the spring of 2017 the European Commission announced that, in view of the prevailing cyclical conditions, it would apply a “margin of discretion” to the assessment of compliance with fiscal rules of member states’ budgetary plans for 2018. Consistent with this approach, the Commission subsequently judged that the 0.3 percentage point improvement in the structural balance envisaged in Italy’s Draft Budgetary Plan 2018 was adequate.

The ex-post change in the structural balance in 2018 (zero according to the SP2019 and -0.1 according to the Commission’s Spring Forecast 2019) did not fulfil the agreed improvement because of two main factors: i) an unexpected reduction in the adjustment for cyclical conditions; ii) unforeseen factors that affected budget performance at year-end.

Indeed, the strong downward revision of GDP growth forecasts for 2019-2022 affected the entire series of potential GDP and output gaps, including the 2018 estimates. The output gap has a significant impact on the cyclically-adjusted balance; the unforeseen revision reduced the achieved structural adjustment. Had the output gap for 2018 stayed equal to the one estimated in the Update published by the government in December 2018 (-1.7 instead of -1.5 percent), the structural balance would have been -1.3 percent instead of -1.4 percent of GDP. The fiscal effort achieved in 2018 would been 0.1 points higher.

In addition, the drop in economic activity in the final months of the year was not fully expected and its effect on the public finances only became clear ex post, once the data became available in early 2019. That did not leave enough time for remedial actions.

Outturn data for one-off measures also contributed to the worsening of the 2018 structural balance. In particular, revenue from property sales and the settlement of past tax liabilities was higher than expected. To some extent, the classification of these budget items occurred ex post and would have been difficult to anticipate.

Finally, capital contributions were 3 billion euro (almost 0.2 percent of GDP) higher than expected, one third of which was due to discounted multi-annual transfers.

All in all, 2018 marked a significant decline in the general government deficit, thanks mostly to an improvement in the primary balance. Budget execution was consistent with the original commitments; deviations from the target for the structural balance were mostly attributable to higher-than-expected (albeit declining) interest payments as a share of GDP and the more technical factors illustrated above.

III. THE OUTLOOK FOR THE PUBLIC FINANCES

III.1 UPDATED MACROECONOMIC PROJECTIONS AND DEFICIT TARGETS IN THE 2019 STABILITY PROGRAM

In late December, based on an agreement reached with the European Commission (EC), the Government issued an update of macroeconomic and budget forecasts for 2019-2021[5]. Projections for the public finances were aligned with the final version of the 2019-2021 Budget, which was ratified by Parliament on 30 December 2018. They featured a general government deficit forecast of 2.0 percent of GDP for 2019, 1.8 percent for 2020 and 1.5 percent for 2021.

The 2019-2021 Budget envisages a close monitoring of the public finances and commits the Government to freezing €2 billion worth of central-government spending allocations. The Government must report to Parliament by the end of July about the evolution of the budget balance. If the updated deficit projections for 2019 are consistent with the annual target, the funds will be released. If they exceed the target, the 2 billion will not be disbursed.

TABLE III.1: SUMMARY OF MACROECONOMIC FRAMEWORK BASED ON POLICY SCENARIO (1) (percentage variations, except where otherwise indicated)

	2018	2019	2020	2021	2022
GDP	0.9	0.2	0.8	0.8	0.8
GDP deflator	0.8	1.0	2.0	1.8	1.6
Consumption deflator	1.1	1.0	2.3	1.9	1.6
Nominal GDP	1.7	1.2	2.8	2.6	2.3
Employment FTE (2)	0.8	-0.1	0.3	0.6	0.5
Employment LF (3)	0.8	-0.2	0.1	0.6	0.6
Unemployment rate	10.6	11.0	11.1	10.7	10.4
Unemployment rate net of the activation effect (4)	10.6	10.5	9.6	9.0	8.8
Current account balance (in % of GDP)	2.6	2.5	2.4	2.4	2.4

(1) Discrepancies, if any, are due to rounding.
(2) Employment expressed in terms of Full Time Equivalent (FTE)
(3) Number of employees according to the Labour Force Survey (LFS).
(4) Estimate of the unemployment rate net of the activation effect on new labour force incentivised by Citizenship Income.

In April, the Stability Program (SP2019) updated the official macroeconomic projections. Largely on account of a sizable downward revision in the GDP growth forecast (real growth for 2019 was lowered from 1.0 to 0.2 percent), the deficit projection for this year was raised from 2.0 to 2.4 percent of GDP. The updated deficit estimate includes the safeguard clause on expenditure mentioned above. Due to revisions to the growth forecasts for the next two years, the SP2019 also raised the deficit projections for 2020 and 2021 to 2.1 and 1.8 percent of GDP, respectively, and set a new 1.5 percent deficit target for 2022.

[5] The Update of the Macroeconomic and Budgetary forecasts is available at: http://www.mef.gov.it/inevidenza/documenti/AggiornamentoQM-economico_e_di_FP.pdf

TABLE III.2: PUBLIC FINANCE INDICATORS (as percentage of GDP) (1)	2017	2018	2019	2020	2021	2022
POLICY SCENARIO						
Net borrowing	-2.4	-2.1	-2.4	-2.1	-1.8	-1.5
Primary balance	1.4	1.6	1.2	1.5	1.9	2.3
Interest	3.8	3.7	3.6	3.6	3.7	3.8
Structural net borrowing (2)	-1.4	-1.4	-1.5	-1.4	-1.1	-0.8
Change in structural balance	-0.4	0.0	-0.1	0.2	0.3	0.3
Public debt (gross of support) (3)	131.4	132.2	132.6	131.3	130.2	128.9
Public debt (net of support) (3)	128.0	128.8	129.4	128.1	127.2	125.9
Privatisation receipts	0.0	0.0	1.0	0.3	0.0	0.0

(1) Discrepancies, if any, are due to rounding.

(2) Net of one-offs and the cyclical component.

(3) Gross or net of Italy's relevant shares of the loans to Member States of the EMU, bilateral or through the EFSF, and of the contribution to the capital of the ESM. Throughout 2018 the amount of these shares was equal to approximately 58.2 billion, of which 43.9 billion for bilateral loans and through the EFSF and 14.3 billion for the ESM program (see Bank of Italy, 'Statistical Bulletin - The Public Finances, borrowing requirement and debt of March 15, 2019). The estimates consider privatisation receipts and other financial income equal to 1% GDP in 2019, 0.3% GDP in 2020 and 0 in subsequent years. Moreover a reduction of the MEF's liquidities of 0.1% GDP for each year from 2019 to 2021 is assumed. The interest rate scenario used for the estimates is based on implicit projections derived from forward rates on Italian government securities with respect to the period for compiling this document.

According to the macroeconomic projections of the SP2019, Italy's output gap would be -1.7 percent of potential GDP in 2019 and -1.6 percent in the three following years. Real GDP growth in 2019 would be lower than potential growth (0.4 percent), while in the three following years it would be roughly in line with potential growth.

Given these estimates, the preventive arm of the Stability and Growth Pact (SGP) requires a structural improvement of 0.25 percentage points in 2019 (growth below potential and output gap wider than -1.5 percent) and 0.5 percent in 2020-2022 (output gap wider than -1.5 percent). In addition, the EC granted Italy a flexibility margin of 0.18 percent of GDP in 2019 for expenditures due to unusual weather events, extraordinary infrastructure maintenance and hydrogeological risk mitigation. Including this margin, the required improvement in the structural balance declines to 0.07 percentage points.

According to the SP2019 forecasts, the structural balance will worsen by 0.1 percentage points this year and then improve by 0.2 points in 2020 and 0.3 points in both 2021 and 2022. The deviation from the benchmarks mentioned above would be of 0.2 percentage points in each year, which would not constitute a significant deviation. Hence, according to the Government's macroeconomic scenario and output gap estimates, the SP2019 is SGP compliant.

TABLE III.3: CYCLICALLY ADJUSTED PUBLIC FINANCE (% OF GDP)	2016	2017	2018	2019	2020	2021	2022
1. GDP growth rate at constant prices	1.1	1.7	0.9	0.2	0.8	0.8	0.8
2. Net borrowing	-2.5	-2.4	-2.1	-2.4	-2.1	-1.8	-1.5
3. Interest expenditure	3.9	3.8	3.7	3.6	3.6	3.7	3.8
4. One-off measures (2)	0.2	0.0	0.1	0.1	0.1	0.1	0.1
of which: *Revenues*	0.3	0.5	0.2	0.1	0.1	0.1	0.1
Expenditures	-0.1	-0.6	-0.1	0.0	0.0	0.0	0.0
5. Potential GDP growth rate	-0.1	0.3	0.6	0.4	0.7	0.8	0.7
Factor contribution to potential growth:							
Labour	-0.1	0.2	0.4	0.1	0.3	0.3	0.1
Capital	-0.1	0.0	0.1	0.1	0.1	0.2	0.2
Total factor productivity	0.0	0.1	0.1	0.2	0.3	0.3	0.4
6. Output gap	-3.1	-1.8	-1.5	-1.7	-1.6	-1.6	-1.6
7. Cyclical component of the budget balance	-1.7	-1.0	-0.8	-0.9	-0.8	-0.9	-0.9
8. Cyclically adjusted budget balance	-0.8	-1.4	-1.3	-1.4	-1.2	-0.9	-0.7
9. Cyclically adjusted primary surplus	3.1	2.4	2.4	2.2	2.4	2.8	3.2
10. Structural budget balance (3)	-1.0	-1.4	-1.4	-1.5	-1.4	-1.1	-0.8
11. Structural primary balance (3)	2.9	2.4	2.3	2.1	2.2	2.6	3.1
12. Change in structural budget balance	-0.9	-0.4	0.0	-0.1	0.2	0.3	0.3
13. Change in structural primary balance	-1.1	-0.5	-0.1	-0.2	0.2	0.4	0.4

(1) Discrepancies, if any, are due to rounding
(2) Positive signs imply that temporary measures reduced the deficit.
(3) Cyclically-adjusted net of one-off and other temporary measures.

III.2 THE OUTLOOK FOR 2019

Economic and budget data that have become available since the SP2019 was released in early April suggest that the updated deficit estimate for this year (2.4 percent of GDP) could be outperformed:

- While the global economic picture remains clouded by significant risks, real GDP growth may exceed the 0.2 percent forecast featured in the SP2019. Indeed, manufacturing and construction activity rebounded in the first quarter, yielding a small gain in real GDP. The expectation of moderate growth in the coming quarters is supported by the improvement in economic sentiment indicators.
- According to preliminary data, the central government borrowing requirement (CGBR) in the first four months of the year was 31.6 billion, only 1.5 billion above the year-ago level. The annual projection foresees an increase in the CGBR to 60.0 billion, from 43.6 billion in 2018. While expenditure on new welfare policies (Citizenship Income and early retirements) only kicked in from the second quarter, the trend in the borrowing requirement is encouraging.
- Tax revenues in the first four months of the year rose by 1.0 percent, ahead of the annual growth forecast of 0.6 percent in the SP2019. Revenues excluding withholding and transaction taxes on financial assets, which were negatively affected by the financial market selloff in the second half of 2018, rose by 1.5 percent year-on-year, a growth rate that exceeds the SP2019 forecast for nominal GDP growth (1.2 percent). Revenue from withholding taxes on private-sector labour income was up 4.0 percent, and VAT proceeds rose by 5.9 percent.

- According to the latest data, other revenue (notably dividend payments by the central bank and state-owned enterprises) will exceed the SP2019 projections by more than 0.1 percent of GDP.
- Applications for Citizenship Income (CI) and for '100 level' (Q100) early retirements so far are significantly lower than the projections underlying the 2019 Budget[6].

In light of these considerations, a continuation of the good performance of tax revenue and a lower take-up of the new welfare policies would create room for outperformance of the official deficit forecasts, including on a structural basis. The 2019 outturn would be at least 0.2 percentage points lower than the Commission's Spring Forecast (2.5 percent), indicating broad compliance with the preventive arm of the SGP.

III.3 THE 2020-2022 PROGRAM

As was mentioned above, the three-year plan presented in the SP2019 aims to gradually reduce the nominal deficit to 1.5 percent of GDP in 2022 even though interest expenditure is projected to rise to 3.8 percent of GDP, from 3.6 percent this year. The structural deficit would improve from 1.5 percent of GDP this year to 0.8 percent in 2022. The primary surplus would reach 2.3 percent of GDP in 2022 (3.1 percent of GDP on a structural basis).

The adjustment envisaged for 2020 is the most significant one. The 2019-2021 Budget includes a hike in indirect taxes worth 23.1 billion in 2020 and a further 5.7 billion in 2021. In 2020, the deficit under existing legislation will decline to 35.9 billion, from 42.1 this year. Adding up the official estimate of recurrent expenditure, according to the SP2019 the no-policy-change deficit would be equal to 38.6 billion (2.1 percent of GDP). The Government already indicated in the SP2019 that the key measures to reach the stated target would be cuts in current expenditure resulting from a comprehensive Spending Review and measures to improve tax compliance.

With the resolution that approved the SP2019, Parliament formally endorsed the deficit targets for 2020-2022. Coalition parties also urged the Government to undertake a spending review and to reform the personal income tax, notably with a reduction in the number of tax brackets and a revision of benefits and allowances. In addition, the parliamentary resolution calls for the repeal of the safeguard clause involving a VAT hike in 2020 without prejudice to the achievement of the official deficit target.

In the Spring Forecast 2019, the EC estimates a 2.5-percent-of-GDP deficit for this year, only one tenth of a percent above Italy's official forecast. However, it projects a shortfall of 3.5 percent in 2020 versus the government's 2.1 percent target. The difference is mostly due to the EC excluding from its computations the safeguard clause on indirect taxes, which is worth almost 1.3 percent of GDP. With the clauses in the count, the

[6] As of 30 April, 1.02 million applications were made for CI. Among the applications processed thus far, at least 25 percent were rejected for failure to meet eligibility criteria. Budgetary projections assumed 1.25 million eligible households. As for Q100, the total number of applications as of 13 May was 131.8 thousand, versus an annual estimate of 290 thousand. While more workers will qualify for Q100 later in the year (three months after turning 62 with at least 38 years of contributions), the take-up will be probably lower than assumed in budgetary projections (85 percent for private sector workers, 70 percent for public sector workers and 100 percent for individuals that qualify for Q100 but are currently unemployed.

difference between the government and EC forecasts would be a mere 0.1 percentage point in both 2019 and 2020.

The broad outlines of the 2020-2022 Budget will be disclosed in September with the Update of the Stability Program. Specific measures will be readied in time for the Draft Budgetary Plan 2020 due in mid-October and the 2020 Budget by October 20th. Also in view of the parliamentary resolution, the Government remains committed to the deficit targets declared in the SP2019.

IV. OUTPUT GAP AND STRUCTURAL BALANCE: ALTERNATIVE ESTIMATES AND COMPLIANCE WITH THE RULES

IV.1 ALTERNATIVE OUTPUT GAPS AND POTENTIAL OUTPUT ESTIMATES

Potential output estimates play a key role in the EU fiscal surveillance process. It is recognized that the measurement of the output gap is a contentious issue and that the recession that hit the advanced economies in 2008 complicated the estimation problems, as the steady growth enjoyed for a long time by most member states was suddenly interrupted by a drop in GDP levels of unprecedented severity and duration. Moreover, once the economy began to recover, growth resumed along a more muted path and some Euro area countries experienced a second and more damaging recession in 2010-2012.

The structural unemployment rate and total factor productivity are the two key components of the production-function methodology adopted by the European Commission to estimate potential output. The way in which the trend component is separated from from the cyclical one critically affects potential output and output gap estimates.

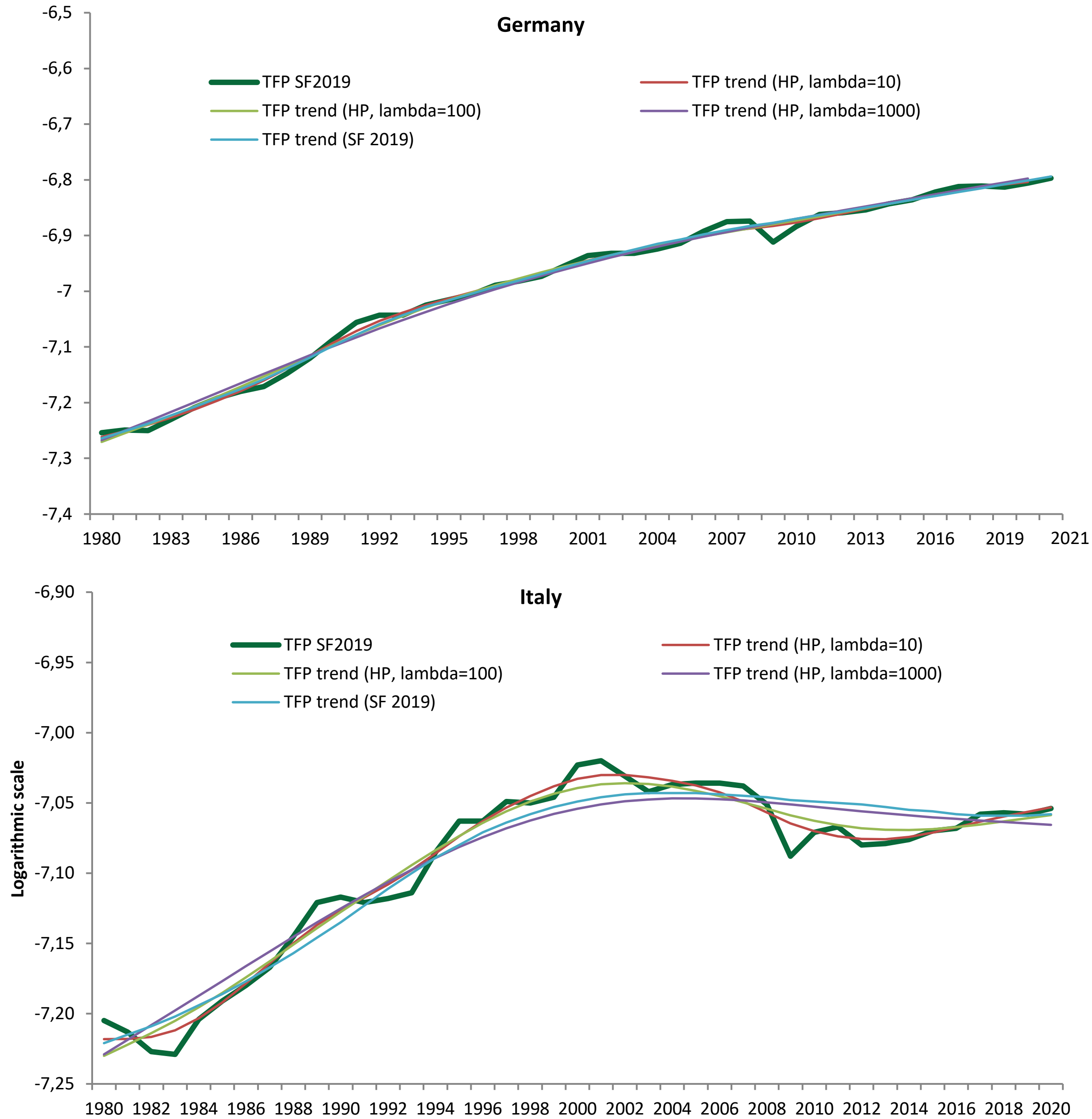
In the case of Italy, the patterns followed by the Solow residual and the unemployment rate in the aftermath of the recession make the estimation of potential output particularly difficult. The key question is whether the trend estimates delivered by the methodology capture the recent recovery of TFP growth and how the NAWRU responds to the gradual decline in the unemployment rate that began in 2014. The following graphs show TFP estimates and their smoothed component (using Hodrick Prescott filters and the the commonly-agreed European methodology) for Italy and Germany.

The graphs show that, while for Germany the TFP trend estimation is rather straightforward and certainly not significantly impacted by the specific trend/cycle decomposition methodology, estimates for Italy are highly sensitive to the chosen methodology and the choice of underlying parameters.

In Italy's case, the latest estimates of the TFP trend by the Commission show a prolonged period of negative growth followed by a slight recovery from 2018 onwards. Projected positive growth rate of productivity are significantly lower than the recent performance of the Italian economy; as they stand, these estimates suggest that the TFP recovery in recent years is mostly cyclical. Given the modelling framework underlying the estimation methodology (a Bayesian Kalman filter), results are highly influenced by the choice of the capacity utilization index (the so-called CUBS) and on the initial values of the parameters underlying the estimates.

The Italian delegation to the Output Gap Working Group (OGWG) has long argued that since 2015 the values of CUBS overstated the actual capacity utilization rate of the Italian economy, as business confidence rose more sharply than actual activity levels. The sharp rise in CUBS caused an overestimation of the cyclical component of TFP and, as a result, produced a a negative TFP trend.

FIGURE IV.1: TREND ESTIMATION OF THE TOTAL FACTOR PRODUCTIVITY



Source: Commission Services Spring Forecasts 2019 and MEF estimates.

The Italian delegation proposed a country-specific modification to the measurement of capacity utilisation which, in combination with CUBS, relied on administrative data on labour hoarding in order to quantify the degree of utilization of productive factors. In the previous Relevant Factors Report (November 2018) it was shown that, by adopting this alternative index, one could have obtained a more positive trend in TFP and relatively higher potential output growth rates. As a result, output gaps over the past few years would have been significantly wider than suggested by the Commission's estimates, registering a -3.2 percent level in 2018. With these more realistic output gap estimates Italy's structural budget balance would have been -0.4 percent of GDP in 2017 and -0.2

percent in 2018. Regardless of flexibility margins granted by the Commission, Italy in 2018 would have broadly achieved its Medium Term Objective of a balanced structural budget.

Following the rejection of this proposal by the OGWG, Italian official policy documents no longer provide alternative estimates based on the labour-hoarding index. This is in the spirit of achieving a commonly-agreed modification to the TFP trend estimation methodology. However, initialization parameters for the Bayesian Kalman filter used for TFP estimation are different from those chosen by the Commission[7]. The way forward would be to improve the measurement of the CUBS variable and to increase the transparency in the selection of the initialization parameters made by the Commission.

Italy's output gap estimates are based on the national macroeconomic forecasts and on a longer time interval with respect to the official EC estimates (T+3 instead of T+1). However, the difference between Italy's output gap estimates and the Commission's 2019 Spring Forecasts seem to be mostly due to the TFP trend component.

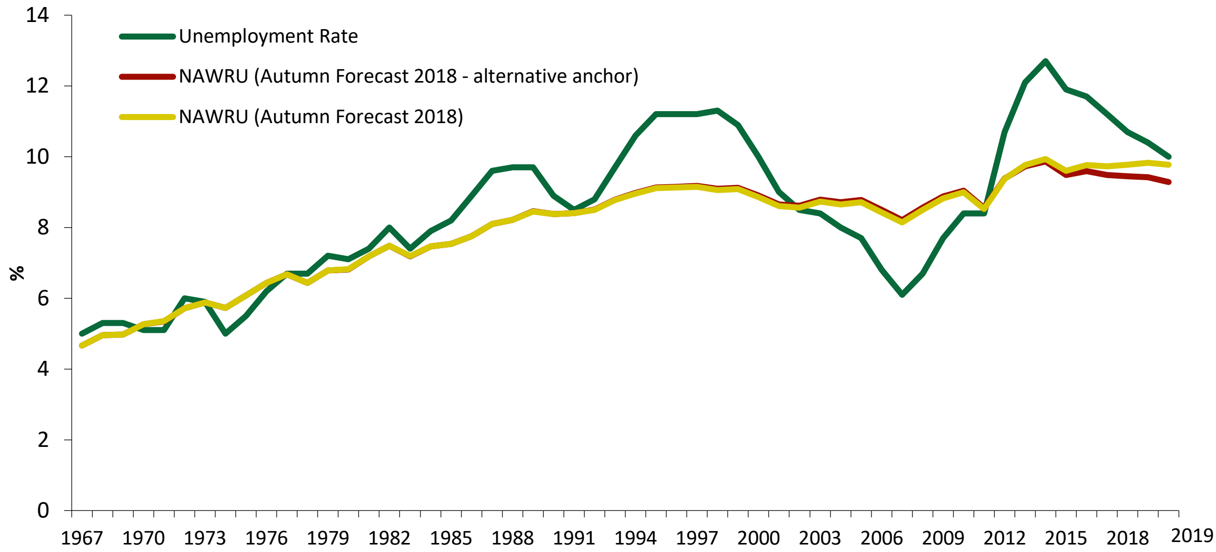
With reference to the NAWRU estimates, as mentioned in the last Relevant Factors Report, progress was made in the course of 2018. Italy proposed to use of an iterative procedure, the so-called grid search, which, on the basis of a set of statistical criteria, selects the initial variance bounds of the model in a less discretionary fashion than previously foreseen. Thanks to the grid search procedure, the NAWRU estimates for Italy are sounder from a statistical point of view. The OGWG agreed to adopt the grid search for Italy and since 2018 the Commission's estimates of NAWRU are produced according to this approach, which in the future could be extended to other EU countries.

This notwithstanding, the official NAWRU projections are still problematic, as in recent years both its level and trajectory are at odds with economic intuition. Figure IV.2 helps to illustrate the question. It shows the unemployment rate and the 2018 Autumn Forecasts estimates for the NAWRU (green line). The unemployment rate peaked in 2014 and has subsequently followed a declining trend. On the contrary, the NAWRU estimates, after a temporary downward rebound, started to rise. As a result, the unemployment gap (i.e., the difference between the unemployment rate and NAWRU) will nearly close in 2020.

A high and rising level of NAWRU seems at odds with economic evidence. Since 2014 Italy has implemented reforms aimed at reducing the structural unemployment rate. Furthermore, wage growth has been very low. If the unemployment gap was shrinking, we should have observed upward pressures on wages, of which there is no evidence in the data. There is broad agreement within the OGWG that the Phillips curve estimation, one of the building blocks of the Kalman filter, is facing significant empirical issues. The fact remains, though, that the official NAWRU projections for Italy resemble an autoregressive process, which seems at odds with the ongoing combination of declining unemployment and near-zero wage inflation.

[7] Under the current procedure, the initialization parameters for the Bayesian Kalman Filter are discretionally selected by the Commission at each Forecast round and are disclosed to Member countries ex post. In turn, every year the Italian government – complying with the National legislation – provides information on its choice of the initialization parameters in a methodological note attached to the Stability Program ("Nota Metodologica sui criteri di formulazione delle previsioni tendenziali"). This year, the parameters are provided in note 59, pp. 40.

FIGURE IV.2 – TREND ESTIMATION OF THE UNEMPLOYMENT RATE



Source: Commission Services Autumn Forecasts 2018 and MEF estimates.

The misspecification of the Phillips curve may not be the only flaw in the current methodology. A recent addition to the methodology foresees the use of the structural rate of unemployment (the so-called 'NAWRU anchor'), the level towards which the NAWRU converges in the medium term (t+10), as the anchoring parameter in the short-term estimation. In recent years the estimated values of anchor have risen. The red line in graph IV.2 shows – *ceteris paribus* – what values Italy's NAWRU would have had in the 2018 Autumn Forecasts if the anchor had been set at a lower and more realistic level than the one used by the Commission (9.75 percent)[8].

It is noticeable how a lower level for the anchor has a visible and plausible impact on the last five years of the NAWRU estimates. Such an alternative profile of the NAWRU would further increase the output gap currently projected by the Italian government. The output gap would show a tendency to widen over time and would approach 2 percent. The profile for the period 2019-2022 would be -1.9, -1.8, -1.9 and -1.9 instead of the -1.7, -1.6 -1.6 and -1.6 sequence featured in the Stability Program 2019.

Considerable effort to improve the quality of the NAWRU anchor estimates has been expended by the OGWG in the past year and the topic is also of primary concern for the 2019 agenda of the Group, as many European countries and the Commission itself share a common view on the flaws of the currently employed panel regression methodology.

Table IV.1 reports output gap estimates for Italy and Germany provided by different International organisations and by Italy's Stability Program. For both countries, national estimates for the last two years are closer to the ones provided by the OECD and the IMF, while European Commission output gaps are quite different and generally closer to zero.

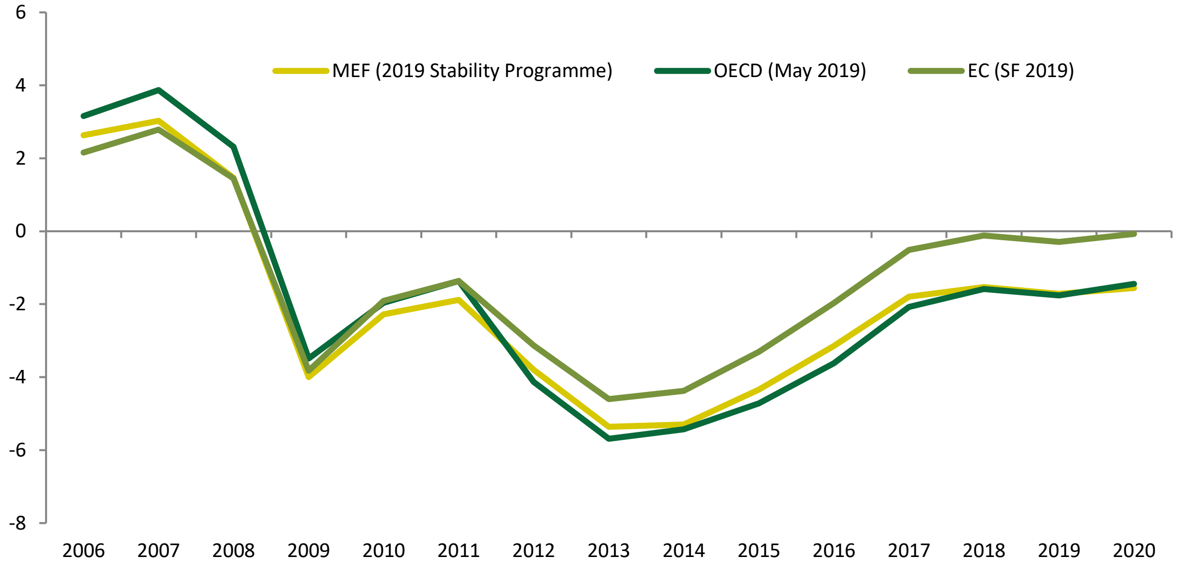
[8] The alternative NAWRU anchor value, set at 8.1, is computed as the average of the unemployment rate from 2000 (the year following the entry of Italy in the Euro Area) to 2007 (before the beginning of the Great Recession).

TABLE IV.1: OUTPUT GAP ESTIMATES						
			ITALY			
	2017	2018	2019	2020	2021	2022
Stability Program 2019	-1.8	-1.5	-1.7	-1.6	-1.6	-1.6
EC (SF 2019)	-0.5	-0.1	-0.3	-0.1		
OECD (May 2019)	-2.1	-1.6	-1.8	-1.4		
IMF (April 2019)	-1.5	-0.9	-1.0	-0.5	-0.2	-0.1
			GERMANY			
	2017	2018	2019	2020	2021	2022
Stability Program 2019		0.8	0.4	0.5	0.2	0.1
EC (SF19)	0.9	0.7	-0.2	-0.1		
OECD (May 2019)	1.6	1.4	0.7	0.4		
IMF (April 2019)	0.9	1.0	0.8	0.6	0.6	0.4

Source: 2019 Stability Program, Commission Services Spring Forecasts 2019, OECD Economic Outlook 2019, IMF World Economic Outlook 2019.

Figure IV.3 highlights that for Italy the output gap series delivered by the OECD for the whole 2000-2020 period are very close to the numbers reported in the 2019 Stability Program and in particular they are very close to the government's assessment of Italy's cyclical position since 2012 (the beginning of the so-called "double dip").

FIGURE IV.3: OUTPUT GAP ESTIMATES FOR ITALY (2006-2020)



Source: 2019 Stability Program, Commission Services Spring Forecasts 2019, OECD Economic Outlook 2019.

A final aspect of the analysis concerns the new welfare measures financed by Italy's 2019 Budget and subsequently introduced by a government decree (Law Decree n. 4, 2019), notably the Citizenship Income benefit. Its implications on the labour market and more generally on GDP were not included in the Autumn Forecast as relevant information was not yet available. Italy's Stability Program 2019 provides an in-depth assessment of the likely effects of the new policies, including on potential output.

Citizenship Income not only provides income support to the poorest sectors of the population (which is a countercyclical feature of the measure) but it also intervenes on the supply side of the labour market. It was conceived as an activation measure (thus raising the participation rate) and can also boost productivity in the medium and long run. The latter effect was assessed using the Quest model (see the 2019 National Reform Program, pp 23-26), though this impact was prudentially not included in the macroeconomic forecast. The short-term macroeconomic impact was assessed by means of the Treasury's econometric model (ITEM), whose supply side responds to the increase in the labour participation rate engendered by the new activation policies. The medium to long-term effects on productivity were simulated with QUEST, though those results were not included in the official 2019-2022 forecast.

The production function methodology cannot quantify the impact of structural reforms on potential output in a general equilibrium context. Therefore, the assessment can only be made by comparing potential output estimates derived from two macroeconomic scenarios: a baseline – no intervention – and one that incorporates the impact of the measure. Hence, the first and more relevant step of the evaluation process can only be made outside the methodology.

In the Stability Program, the assessment of Citizenship Income via the econometric model took into account jointly the increase in the participation rate and in the unemployment rate (both variables rise during the first year of the implementation, with some carryover in the second) with respect to a baseline scenario. All other fiscal policy changes (and implication on income flows) were equally factored in. This led to an overall economic impact stemming from the 'model properties' of ITEM[9]. The implications for potential output were derived by using the set of input variables from the two scenarios and estimating potential output for each of them[10]. Potential output was estimated out to year T+3, which is particularly appropriate given the medium term impact of the reform.

The outcome of the analysis is summarized in table IV.2, which shows the difference of actual and potential output growth versus the baseline.

TABLE IV.2: EFFECTS OF 'CITIZENSHIP INCOME' POLICY ON REAL AND POTENTIAL GROWTH

	2017	2018	2019	2020	2021	2022
Real Growth	0.0	0.0	0.2	0.2	0.1	0.0
Potential Growth	0.1	0.2	0.2	0.0	0.4	0.2

Source: 2019 Stability Program (p.74-82).

The implications are quite straightforward: while in the short term (2019-2020) there is a stronger effect on GDP, the impact on potential output growth is more noticeable at a later stage (2021-2022). However, potential output is also affected in the past (2017-2018). Intuitively, the favourable impact on the participation rate, whose values suddenly rise, will be diluted trough time when concerning its trend component; the latter is decomposed with an HP filter and its increase is gradual. The positive impact on potential is offset in the initial years as the NAWRU also increases; the Kalman Filter reacts faster to the rise of headline unemployment than the HP-filtered participation rate. Later on this countereffect fades away, partly because of the features of the filter, partly because unemployment starts declining as newly activated people gradually become employed.

[9] Stability Program 2019, p. 34-36.
[10] Stability Program 2019, p. 74-82)

The main takeway is that the labour activation effect of Citizenship Income raises potential output by more than actual GDP rises due to the income transfer component of this new policy. As a result, the output gap widens by a few tenths of a percentage point in the 2019-2022 period.

In conclusion, we have shown that starting from the prudent macroeconomic forecasts of the Stability Program 2019 (which were endorsed by the independent fiscal council UPB) and adopting a lower (but quite realistic) estimate of the NAWRU 'anchor,' the commonly agreed methodology yields an estimate of Italy's output gap of around -2 percent throughout the 2019-2022 period. This compares with Commission estimates of -0.3 percent for 2019 and -0.1 percent for 2020. The difference is large enough to heavily influence the assessment of past compliance and of the required structural adjustment in 2019-2020.

IV.2 CYCLICAL CONDITIONS AND THE DEBT RULE

Compliance with the debt criterion has become extremely demanding for Italy in a context of low inflation and economic growth. Figure IV.4 shows the gap with the debt reduction benchmarks in all debt rule configurations for 2018 both under the policy scenario of the 2019 Stability Program and the no-policy change scenario assumed by the Commission in the 2019 Spring Forecasts.

Italy is estimated to be noncompliant for the year 2018 in all debt rule configurations. When using the backward-looking configuration, the gap to the debt benchmark is 7.6 percentage points. Gaps versus the forward-looking debt benchmark reflect the projected levels of the debt ratio in coming years. According to the official forecast, the gap is 6.2 percentage points, whereas Commission Spring forecast implies a much wider gap of 9.8 points. The different views on the cyclical position of the Italian economy are highlighted by the gap versus the cyclically-adjusted debt benchmark. In this configuration too the gap estimated by the Commission is larger.

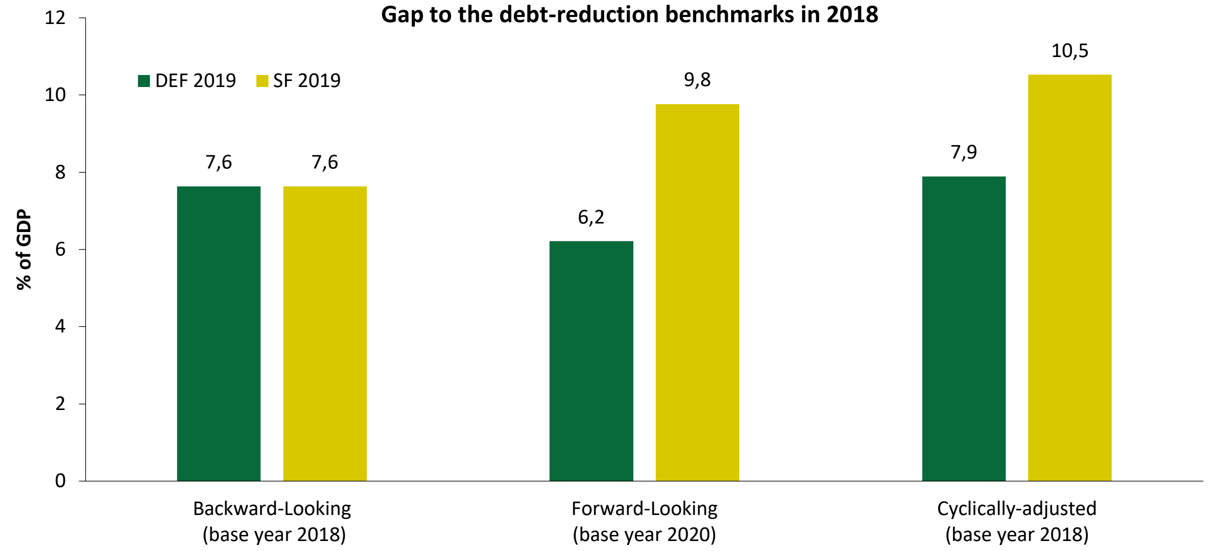
The debt-reduction rule was designed in a era when the goal of 2 percent inflation still seemed within reach. Figure IV.5 shows how the gap to the debt benchmark derived for 2018 as estimated in the cyclically adjusted configuration would change under two alternative scenarios: i) inflation at 2 per cent[11], and ii) excluding the extraordinary interventions in support of the banking sector adopted in 2017.

By assuming a GDP deflator growth of 2 percent per year over the period 2016-2018[12], the gap to the debt-reduction benchmark in the SP2019 scenario would be smaller, 3.5 points. Furthermore, excluding the extraordinary interventions in support of the banking sector, the gap to the debt-reduction benchmark in the SP2019 scenario would further decline to 2.6 percent of GDP.

[11] The assumption for the GDP deflator is in line with the historical dynamic for Italy. Indeed, the deflator averaged almost 1.9 per cent over the period 2000-2015. Moreover, the assumption of a GDP deflator at 2 percent is fully in line with the cyclical correction approach.

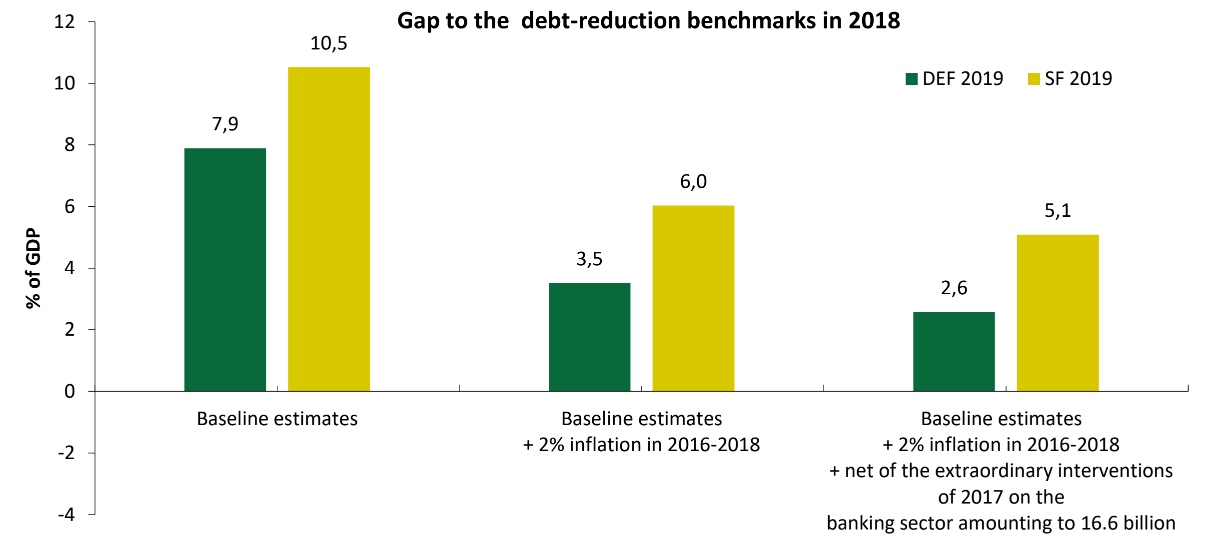
[12] *t-2* to *t* is the period considered when computing the cyclically-adjusted debt according the commonly-agreed methodology.

FIGURE IV.4: GAPS TO THE DEBT REDUCTION BENCHMARKS: RESULTS FROM THE 2019 STABILITY PROGRAM VS 2019 SPRING FORECASTS



Source: MEF elaborations on 2019 SP and on Commission Services 2019 Spring Forecasts.

FIGURE IV.5: GAPS TO THE DEBT REDUCTION BENCHMARKS IN THE CYCLICALLY-ADJUSTED CONFIGURATION



Source: MEF computations on 2019 Stability Program and European Commission Spring Forecast 2019.

V. NEW POLICIES FOR SOCIAL INCLUSION

V.1 BACKGROUND DATA AND RECENT TRENDS

Social vulnerability and inequality increased in most EU member states following the global financial crisis. As a result, the issues of poverty and inequality moved to the top of the European policy agenda. Reforms and policies to foster social inclusion are now the focus of the European Pillar of Social Rights within the European Semester.

Monitoring of member states' performance in relation to the Social Scoreboard of employment and social indicators set up within this Pillar has identified Italy as one of the countries with significant gaps. In the most recent Joint Employment Report (2019), the Social Scoreboard suggests that Italy is in a "critical situation"[13] with respect to seven indicators, the employment rate, the youth NEET rate, the gender employment gap, early leavers from education and training, GDHI per capita growth, the impact of social transfers on poverty reduction and the long-term unemployment rate. Other indicators for Italy are rated as being "to watch", in particular the "at risk of poverty or social exclusion rate" and the "unemployment rate". Italy is also "weak but improving" with respect to inequality as measured by the income quintile ratio.

Social exclusion, poverty and inequality are thus priority issues for Italy, as confirmed by findings reported in the most recent Joint Employment Reports (JER) (2018, 2019), Country Reports for Italy (2018, 2019) and CSRs 2018. Improving social inclusion in Italy is also a major focus of the 2019 OECD Economic Survey of Italy.

Poverty and Inequality - recent trends. Within the EU, people are considered at risk of poverty and social exclusion (AROPE) when they experience one or more of the following three conditions: a) being at risk of poverty[14]; b) being severely materially deprived[15]; c) living in a household with a very low work intensity.[16] In the period 2005-2017 the AROPE rate shows quite a stable trend at EA-19 level (and at EU-28 level since 2010) but country differences emerge looking at Figure V.1. For the whole period, AROPE levels are lower for France and Germany compared to Italy and Spain. After the 2008 crisis, AROPE rose in the latter two countries, recording higher levels in Italy (except for 2014). Furthermore, in 2007 AROPE in Italy was 4.1 percentage points higher than the EA-19 average and the gap widened to 6.8 percentage points in 2017. In particular, AROPE peaked in 2016 (30

[13] Ratings are "best performers", "better than average", "on average", "good but to monitor", "weak but improving", "to watch", and, finally, "critical situations".

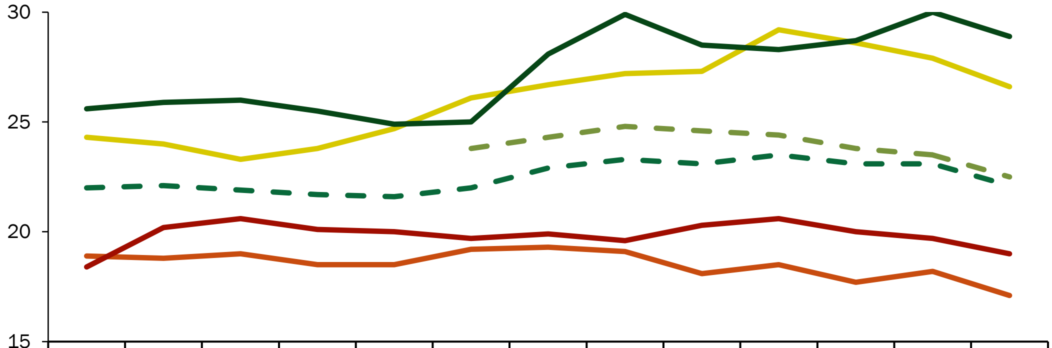
[14] This condition implies living in a household with an equivalised disposable income below 60 percent of the national median equivalised disposable income.

[15] The indicator for severe material deprivation measures the share of persons whose living conditions are severely constrained by a lack of resources. They experience at least 4 out of 9 of the following deprivations: they cannot afford i) to pay rent or utility bills, ii) keep home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) a week holiday away from home, vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone. For details on the related indicator see: https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Material_deprivation.

[16] The corresponding indicator is defined as the number of persons living in a household where the members of working age worked less than 20 % of their total potential during the previous 12 months.

percent, +6.9 on EA-19 average), increasing by 4 percentage points since 2007, and only moderately declined in 2017, reaching 28.9 percent.

FIGURE V.1: PEOPLE AT RISK OF POVERTY AND SOCIAL EXCLUSION (AROPE), PERCENTAGE OF TOTAL POPULATION, 2005-2017 (1)

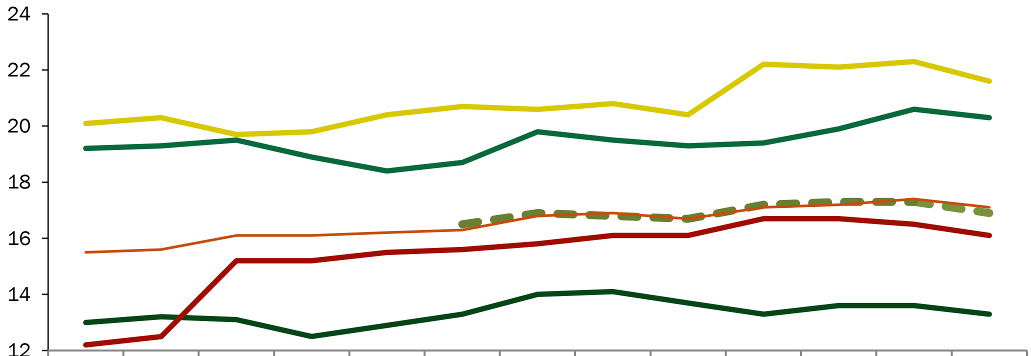


	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU28						23,8	24,3	24,8	24,6	24,4	23,8	23,5	22,5
EA19	22	22,1	21,9	21,7	21,6	22	22,9	23,3	23,1	23,5	23,1	23,1	22,1
Spain	24,3	24	23,3	23,8	24,7	26,1	26,7	27,2	27,3	29,2	28,6	27,9	26,6
France	18,9	18,8	19	18,5	18,5	19,2	19,3	19,1	18,1	18,5	17,7	18,2	17,1
Germany	18,4	20,2	20,6	20,1	20	19,7	19,9	19,6	20,3	20,6	20	19,7	19
Italy	25,6	25,9	26	25,5	24,9	25	28,1	29,9	28,5	28,3	28,7	30	28,9

Source: Eurostat, EU-SILC.
(1) The indicator refers to the year of the EU-SILC survey (t) but income data and data for work intensity refer to the previous year (t-1).

With specific regard to income poverty, i.e. the at risk of poverty rate (AROP) which is one of three underlying AROPE sub-indicators, Italy records higher levels (by around 3 percentage points on average) over the entire decade 2007-2017 compared to the EA-19 average (Figure V.2). In 2017 AROP in Italy is 20.3 percent while the EA-19 average is 17.1 percent (see Annex 1 for trends on AROPE non-monetary sub-indicators).

FIGURE V.2: PEOPLE AT RISK OF POVERTY (AROP), PERCENTAGE OF TOTAL POPULATION, 2005-2017 (1)

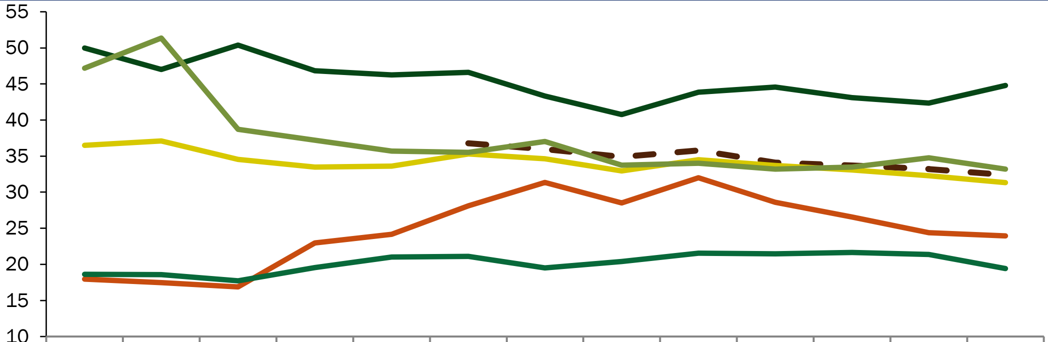


	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU28						16,5	16,9	16,8	16,7	17,2	17,3	17,3	16,9
EA19	15,5	15,6	16,1	16,1	16,2	16,3	16,8	16,9	16,7	17,1	17,2	17,4	17,1
Spain	20,1	20,3	19,7	19,8	20,4	20,7	20,6	20,8	20,4	22,2	22,1	22,3	21,6
France	13	13,2	13,1	12,5	12,9	13,3	14	14,1	13,7	13,3	13,6	13,6	13,3
Germany	12,2	12,5	15,2	15,2	15,5	15,6	15,8	16,1	16,1	16,7	16,7	16,5	16,1
Italy	19,2	19,3	19,5	18,9	18,4	18,7	19,8	19,5	19,3	19,4	19,9	20,6	20,3

Source: Eurostat, EU-SILC.
(1) The indicator refers to the year of the EU-SILC survey (t) but income data refer to the previous year (t-1).

A key element is the effectiveness of policy interventions in reducing poverty and social exclusion through social transfers. This has been identified as a critical area for Italy (JER 2019). One way of monitoring the effectiveness of policy interventions is by looking at the reduction of the AROP rate thanks to social transfers, calculated by comparing at risk of poverty rates before social transfers with those after transfers (Figure V.3).

FIGURE V.3: IMPACT OF PUBLIC POLICIES ON REDUCING POVERTY (REDUCTION IN PERCENTAGE OF AROP RATE), 2005-2017 (1)



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU28						36,8	36,0	34,9	35,8	34,1	33,7	33,2	32,4
EA19	36,5	37,1	34,6	33,5	33,6	35,3	34,6	32,9	34,5	33,7	33,1	32,3	31,3
Spain	18,0	17,5	16,9	23,0	24,2	28,1	31,3	28,5	32,0	28,6	26,6	24,4	23,9
France	50,0	47,0	50,4	46,8	46,3	46,6	43,3	40,8	43,9	44,6	43,1	42,4	44,8
Germany	47,2	51,4	38,7	37,2	35,7	35,5	37,1	33,7	34,0	33,2	33,5	34,8	33,2
Italy	18,6	18,6	17,7	19,6	21,0	21,1	19,5	20,4	21,5	21,5	21,7	21,4	19,4

Source: Eurostat, EU-SILC.
(1) The indicator refers to the year of the EU-SILC survey (t) but income data refer to the previous year (t-1).

In the period 2007-2017 Italy records lower levels of this indicator compared to both the EA-19 average and the selection of countries in Figure V.3. More specifically, in 2007 the level of the indicator in Italy was 16.9 percentage points lower than the EA-19 average. Although this gap has closed somewhat over the following years, the average gap of 13.2 percentage points with respect to the EA-19 average remains quite high. Furthermore, in 2017 public policies in Italy reduced the “at risk of poverty rate before social transfers” by only 19.4 percent (2.0 percentage points lower than 2016), which is the lowest value recorded since 2007.

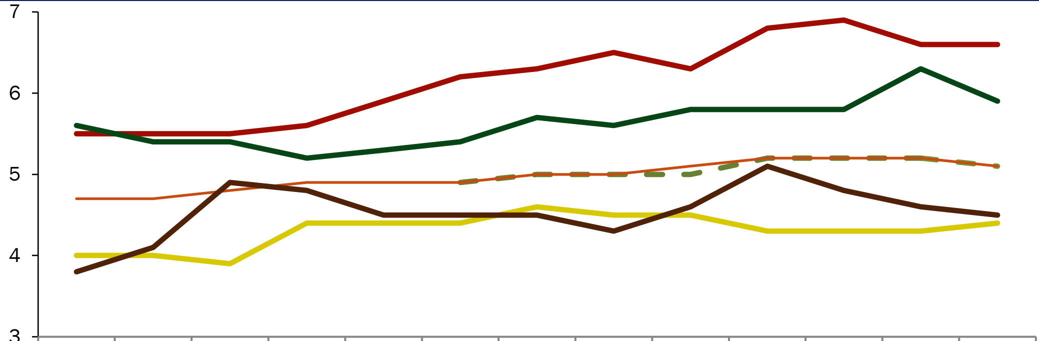
Further insights on social inclusion in Italy are provided by the recent trends in inequality (Figure V.4; see also Annex 1).

In this regard, the income quintile share ratio (S80/S20), which is calculated as the ratio of total income received by the 20 percent of the population with the highest income (top quintile) to that received by the 20 percent of the population with the lowest income (bottom quintile), reveals that Italy records income inequality levels higher than the EA-19 average. Before 2008 the S80/S20 indicator records a slightly declining trend but after the crisis an upward trend can be observed (with the exception of 2012). However, in 2017 a reduction of 0.4 points is recorded, leading to a S80/S20 value of 5.9.

Finally, it is also useful to look at recent trends of the measure of absolute poverty, based on family consumption, developed in Italy since 1997[17].

[17] The Italian National Statistics Office (Istat) publishes estimates on absolute poverty in Italy annually. The head count ratio for absolute poverty is also one of the equitable and sustainable well-being indicators (ESW)

FIGURE V.4: INCOME INEQUALITY (EQUIVALISED DISPOSABLE INCOME) MEASURED BY THE QUINTILE SHARE RATIO (S80/S20), 2005-2017 (1)

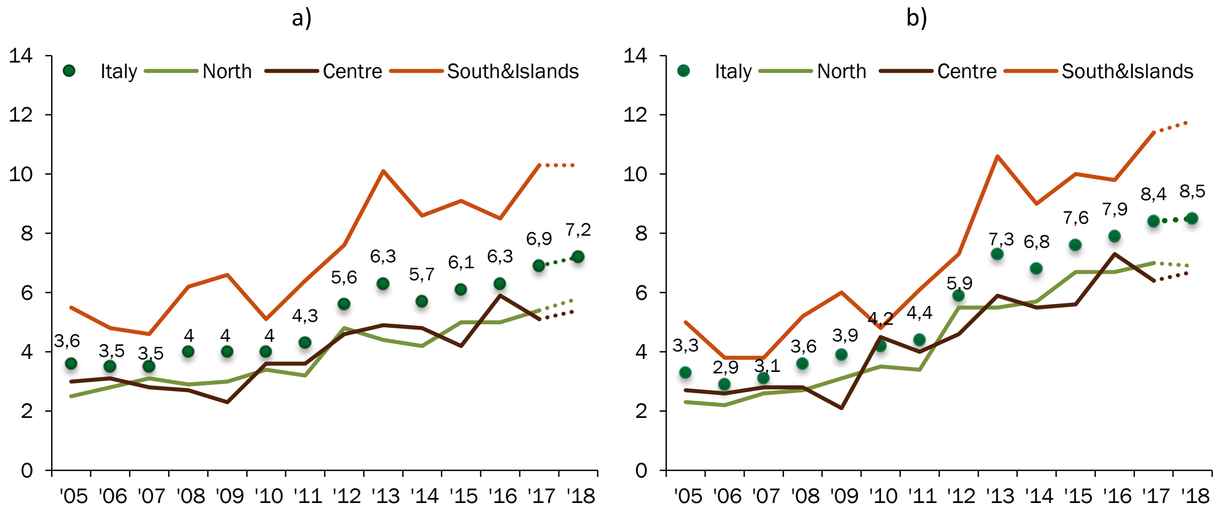


	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU28						4,9	5	5	5	5,2	5,2	5,2	5,1
EA19	4,7	4,7	4,8	4,9	4,9	4,9	5	5	5,1	5,2	5,2	5,2	5,1
Spain	5,5	5,5	5,5	5,6	5,9	6,2	6,3	6,5	6,3	6,8	6,9	6,6	6,6
France	4	4	3,9	4,4	4,4	4,4	4,6	4,5	4,5	4,3	4,3	4,3	4,4
Germany	3,8	4,1	4,9	4,8	4,5	4,5	4,5	4,3	4,6	5,1	4,8	4,6	4,5
Italy	5,6	5,4	5,4	5,2	5,3	5,4	5,7	5,6	5,8	5,8	5,8	6,3	5,9

Source: Eurostat, EU-SILC.
(1) The indicator refers to the year of the EU-SILC survey (t) but income data refer to the previous year (t-1).

Data on absolute poverty (Figure V.5) highlight, beyond an increasing trend at national level, the existing strong regional differences: while absolute poverty levels in the Center and in the North are not very different, absolute poverty levels in the Southern regions are higher over the entire period considered, with respect to other geographical areas. Specifically, the average gap in the incidence of absolute poverty is about 3.4 percentage points, between both Southern and Northern regions and Southern and Central regions. Istat provisional estimates for these gaps in 2018 are 4.5 and 4.9 percentage points, respectively.

FIGURE V.5: ABSOLUTE POVERTY (HEAD COUNT RATIO) AT FAMILY (a) AND INDIVIDUAL (b) LEVEL BY AREA, 2005-2018 (1)



Source: Istat, *Indagine sulle spese delle famiglie*.
(1) 2018: Istat provisional data.

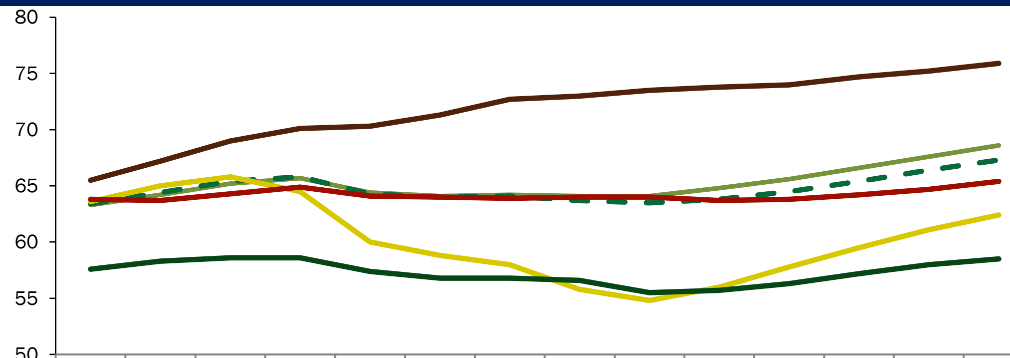
---

that were incorporated into the policy making process according to the reform law n. 163/2016, which modified the budget law n. 196 of 2009.

Given the trends of poverty and inequality reported in the figures above, a substantial increase in income support for individuals and households is needed in order to improve social inclusion in Italy.

Labour market – recent trends. Fundamental for improving social inclusion is greater participation in the labour market and employment. As shown by the Social Scoreboard and mentioned above, Italy scores significantly below other EU Member states on all employment and unemployment indicators. The divergence between Italy and selected Member states, as well as that between Italy and EU and EA averages, is shown in Figure V.6 for the years 2005-2018. The divergence remains high over the entire period examined (except for Spain), despite small increases in the employment rate in Italy from 2014 on. With respect to EU and EA averages, the divergence slightly increased over the years 2015-2018, with a difference in 2018 of 10.1 percentage points between the average EU employment rate and the employment rate in Italy, and a 8.8 percentage point difference between the EA and Italy. These differences are to a large extent explained by very low employment rates for females (see Figure A2.2 in Annex 2) and youth (see Figure A2.3 in Annex 2).

FIGURE V.6: EMPLOYMENT RATE, PERCENTAGE OF TOTAL POPULATION, 2005-2018

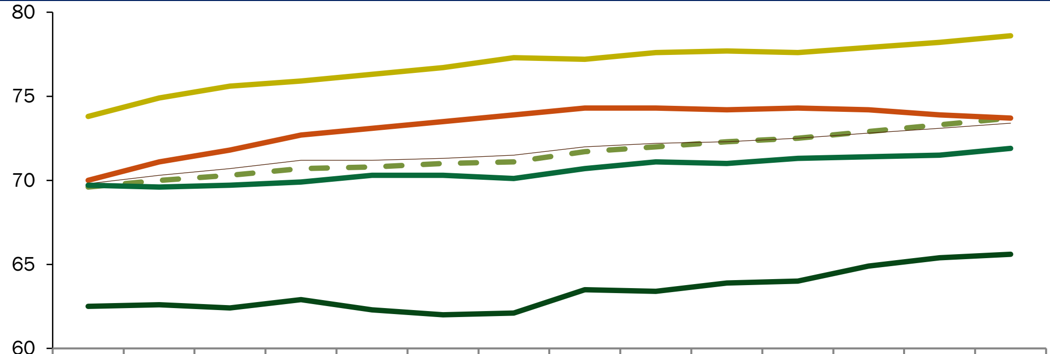


	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EU28	63,3	64,2	65,2	65,7	64,4	64,1	64,2	64,1	64,1	64,8	65,6	66,6	67,6	68,6
EA19	63,4	64,4	65,4	65,8	64,3	64,0	64,1	63,7	63,5	63,8	64,5	65,4	66,4	67,3
Germany	65,5	67,2	69,0	70,1	70,3	71,3	72,7	73,0	73,5	73,8	74,0	74,7	75,2	75,9
Spain	63,6	65,0	65,8	64,5	60,0	58,8	58,0	55,8	54,8	56,0	57,8	59,5	61,1	62,4
France	63,8	63,7	64,3	64,9	64,1	64,0	63,9	64,0	64,0	63,7	63,8	64,2	64,7	65,4
Italy	57,6	58,3	58,6	58,6	57,4	56,8	56,8	56,6	55,5	55,7	56,3	57,2	58,0	58,5

Source: Eurostat, Labour Force Survey.

The trend of participation rates in Italy remains significantly below those of the other major EA countries, as well as EU and EA averages, over the entire period examined. Again, very low participation rates for females (Figure A2.5 of Annex 2) and youth (Figure A2.6 of Annex 2) explain the divergence in trends between Italy and other EU Member states.

FIGURE V.7: ACTIVE RATE, PERCENTAGE OF POPULATION FROM 15 TO 64 YEARS, 2005-2018



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EU28	69,6	70,0	70,3	70,7	70,8	71,0	71,1	71,7	72,0	72,3	72,5	72,9	73,3	73,7
EA19	69,8	70,3	70,7	71,2	71,2	71,3	71,5	72,0	72,2	72,3	72,5	72,8	73,1	73,4
Germany	73,8	74,9	75,6	75,9	76,3	76,7	77,3	77,2	77,6	77,7	77,6	77,9	78,2	78,6
Spain	70,0	71,1	71,8	72,7	73,1	73,5	73,9	74,3	74,3	74,2	74,3	74,2	73,9	73,7
France	69,7	69,6	69,7	69,9	70,3	70,3	70,1	70,7	71,1	71,0	71,3	71,4	71,5	71,9
Italy	62,5	62,6	62,4	62,9	62,3	62,0	62,1	63,5	63,4	63,9	64,0	64,9	65,4	65,6

Source: Eurostat, Labour Force Survey.

V.2 CITIZENSHIP INCOME AND ACTIVE LABOUR MARKET POLICIES

The Italian Government recently introduced new policies to improve social inclusion, lower poverty rates and increase labour force participation and employment. More specifically, the Citizenship Income[18] and reinforced Active Labour Market Policies (ALMPs) are expected to turn around the present social-economic situation, marked by significant poverty, inequality and social exclusion – a legacy of the global financial crisis that led to two major recessions in Italy.

Citizenship Income fills a gap in social protection and is accompanied by strong incentives to participate in the labour market, with funds being provided to significantly improve the functioning of public employment services to ensure employment of the new participants in the labour market. The purpose of the Citizenship Income is thus twofold: (i) to support the income of families below the relative poverty line (as determined by ISEE, the indicator of the economic situation of households that takes into account composition, income and wealth); (ii) to provide a strong incentive to (re)enter the labour market, supported by a significant reinforcement of public employment services.

Citizenship Income is expected to have a significant impact on a number of relevant employment and social indicators. These include poverty and inequality indicators, as well as participation and employment rates (especially of women and youth).

[18] A detailed description of the functioning of the Citizenship Income as well as the related reform of public employment services is given in Section III of the Economic and Financial document published by the Government last April.

Impact on poverty and inequality. Estimates regarding the impact of the Citizenship Income on absolute poverty are reported in Table V.1[19]. The estimated reduction in absolute poverty of households is significant and equal to 1.6 percentage points, falling from 6.9 to 5.3 percent of the population. The estimated reduction in absolute poverty of households is different, however, across regions. More specifically, in southern regions the estimated reduction in absolute poverty of households is equal to 3.7 percentage points (from 10.3 to 6.6 percent) while the reduction in the central and northern regions is more limited (0.8 and 0.5 percentage points, respectively). With regard to absolute poverty of individuals, the estimated reduction at the national level is equal to 1.4 percentage points (from 8.4 to 7.0 percent). The estimated impact of Citizenship Income in terms of reduction in absolute poverty of individuals is also greater in the southern regions compared with central and northern regions.

The estimated impact of the Citizenship Income in terms of the intensity of poverty is 5.2 percentage points at the national level (from 20.9 to 5.7); the estimated reduction is equal to 4.3 percentage points in the north, 3.9 percentage points in the center and 6.7 percentage points in the south.

TABLE V.1: CITIZENSHIP INCOME IMPACT EVALUATION ON ABSOLUTE POVERTY

	PRE Citizenship Income (2017)			POST Citizenship Income		
	Head count ratio (household)	Head count ratio (individual)	Intensity of poverty	Head count ratio (household)	Head count ratio (individual)	Intensity of poverty
North	5,4	7,0	20,1	4,8	6,5	15,9
Centre	5,1	6,4	18,3	4,3	5,6	14,4
South	10,3	11,4	22,7	6,6	8,4	16,0
Italy	6,9	8,4	20,9	5,3	7,0	15,7

Source: PRE Citizenship Income (2017): Istat, *Indagine sulle spese delle famiglie*; POST Citizenship Income: MEF impact evaluation.

Figure V.8 reports the trend of income inequality (equivalised disposable income) for the period 2016-2018 and an estimate for the temporal horizon of the most recent Economy and Finance Document (2019-2022).[20]

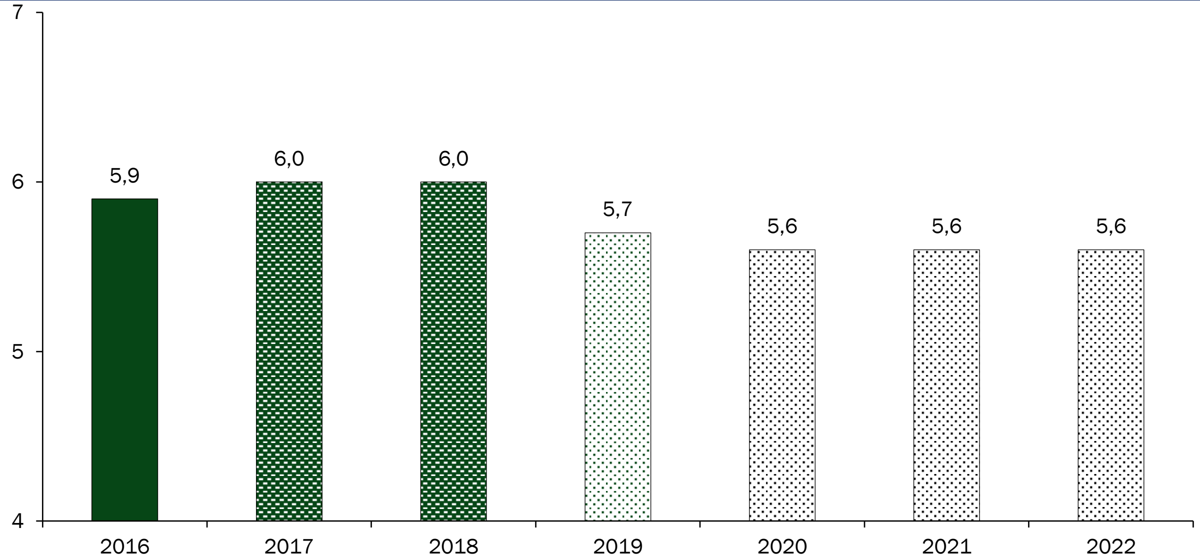
In 2019 the income inequality indicator shows a clear improvement with respect to 2018, with a reduction of 0.3 percentage points, falling from 6.0 to 5.7. This improvement is essentially due to the Citizenship Income and related policies introduced to help households and individuals at the lowest income quintiles.[21]

[19] For more details on the evaluation of the impact of the Citizenship Income on absolute poverty, see the recently published document "Allegato degli indicatori di benessere equo e sostenibile al DEF 2019", available on the website of the Ministry of Economy and Finance.

[20] For a detailed description of the estimation of this indicator, see the recently published document "Allegato degli indicatori di benessere equo e sostenibile al DEF 2019", available on the website of the Ministry of Economy and Finance.

[21] See the previous footnote.

FIGURE V.8: INCOME INEQUALITY (EQUIVALISED DISPOSABLE INCOME) MEASURED BY THE QUINTILE SHARE RATIO (S80/S20), 2016-2022 (1)



Source: 2016-2018: Istat, EU-SILC; 2017 and 2018 are Istat flash estimates. 2019-2022: MEF forecast.
(1) Data refers to the income reference year (t-1) and not to the year of the EU-SILC survey (t). Example: the value for 2016 in this graph corresponds to value for 2017 in Figure V.4.

Impact on the labour market. In figure V.9 the estimated values of non-participation rates (NPR) are shown, decomposed by gender, for both the policy scenario and the scenario based on unchanged legislation.

In the policy scenario a slight increase in total NPR is observed in 2019, due to an increase in NPR for males (0.5 percentage points) and a smaller reduction for females (0.2 percentage points). From 2020 the NPR begins to fall once again, reaching a value of 19.5 in 2022 (lower than the value for 2018). These forecasts are determined by the trends of the variables that compose the NPR.[22]

Over the time horizon of the Stability Program, after a slight reduction in employment in 2019 there is a significant increase in the following years.

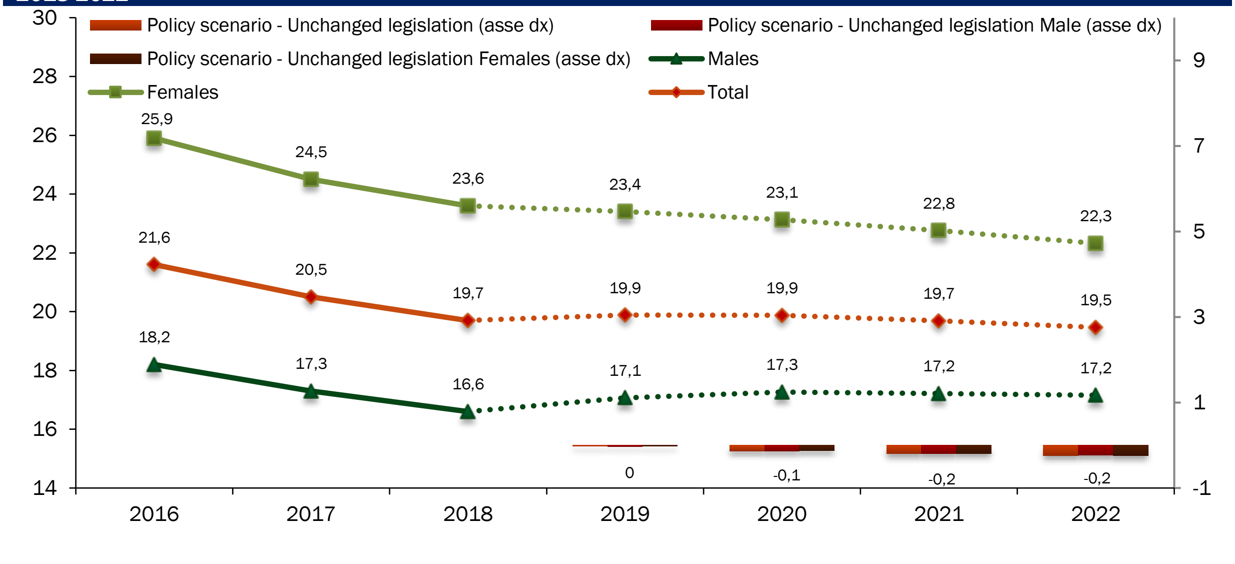
For the years 2019-2022, the dynamics of the NPR is different for men with respect to women: in the first case there is essentially stability, while in the second case a persistent reduction is foreseen. In the case of the male population, the incidence of inactive available persons increases over the entire forecast period, whereas for the female population there is a reduction in the number of inactive available persons in every year except 2021. The combination of these trends along with those of the other components of the NPR produces the diverging trends highlighted in the graph between males and females.

These trends are essentially due to the effects on the labour market produced by the Citizenship Income and measures regarding early retirements. Also, recent measures to stimulate investment by private and local territorial entities (D.L. 'Crescita'), as well as those to simplify procedures to approve public works (D.L. 'Sblocca Cantieri'), contribute to a gradual improvement of the labour market from 2021.

---

[22] For a complete explanation of these trends, see Section II.7 of the recently published document "Allegato degli indicatori di benessere equo e sostenibile al DEF 2019", available on the website of the Ministry of Economy and Finance.

FIGURE V.9: NON-PARTICIPATION RATE , PERCENTAGE VALUE TOTAL POPULATION, MALES AND FEMALES 2018-2022



Source: 2016-2018 Istat, Labour Force Survey. 2019-2021: MEF forecasts.

V.4. ACTIVE LABOUR MARKET POLICIES

The design of a new governance of ALMPs started with the Jobs Act in 2014. In this governance scheme, the Ministry of Labor adopts the three-year guidelines and annual objectives at territorial level. Regional governments are responsible for developing and implementing ALMPs. The role of the new agency (ANPAL), established in 2015, is to coordinate ALMPs as well as the national Network of Public Employment Services (PES).

By comparing the Italian system with those of France and Germany, the competence for the governance of ALMPS in these two member states is assigned to a state agency which manage both subsidies and active labour market services, based on a one-stop shop model. In Germany the Federal Employment Agency (BA) is organized on three administrative levels: headquarters, 10 regional offices, 156 local agencies, 303 job centers and 105 municipal job centers managed by the commons. In 2018 almost 99,000 people were employed in the BA. In France, the provision of labor policy services is delegated to Pôle Emploi, in which 55,000 people were employed in 2018.

The Italian public network of PES comprises 552 job centers (CPI). In 2018, 8,189 workers were employed in the CPI. By looking at the ratio of job seekers to CPI workers, Italy stands at 359 individuals per operator, in Germany and France this potential workload decreases, respectively, to 33 and 30 individuals per operator. According to Istat, with respect to the financial resources for PES, in 2015 Italy used resources equal to 0.04 percent of GDP, significantly less than in Germany (0.36 percent), France (0.25 percent) and Spain (0.14 percent). According to the Labor Force Survey data, PES have so far played a marginal role in Italy compared to other European countries. In 2017 in Italy only 25.4 percent of the unemployed turned to the CPI; the corresponding values for Germany and France and Spain are 74.5 percent, 58.1 percent and 25.2 percent, respectively.

In order to solve the solve the problem of scarce resources dedicated to PES as well as the needs of specific skills to implement more specialized services (counselors /

psychologists, cultural mediators), the Decree Law n. 4/2019 implementing the Citizenship Income envisages a robust strengthening of the PES system, including both infrastructural and technological upgrading and the recruitment of qualified workers.

New PES employees called 'navigators' will follow the beneficiary in his/her job search, training and professional placement, and to this end resources are foreseen for the three-year period 2019-2021. Specifically, 200 million euros are allocated in 2019, 250 million euros in 2020 and 50 million in 2021. Labour contracts will be awarded by ANPAL Servizi. Regions will hire the PES workers for which the Budget Law 2019 allocated 120 million euros in 2019 and 160 million euros starting from 2020. The strengthening of the PES envisaged by Decree Law no. 4/2019 will improve their effectiveness in terms of the job search channel, bringing the Italian system to EU levels thanks also to an extensive use of information technology.

VI. PUBLIC DEBT STRUCTURE, CONTINGENT LIABILITIES AND FINANCIAL RESILIENCE

VI.1 PUBLIC DEBT STRUCTURE

Central government securities account for 84 percent of general government debt. At the end of December 2018 the stock of government securities was 2.8 percent higher than at the end of 2017. In recent decades the composition of debt ensured a high resilience to financial risks (such as refinancing, interest, inflation and exchange rate risks), mitigating the effect of market turbulence even in the wake of the sovereign debt crisis in 2010-2012. This has also been true since mid-May 2018 when Italian sovereign bond yields increased and became more volatile.

Indeed, notwhistanding the above mentioned increase of the stock of government securities, which reached 1,959,4 billion euros at the end of December 2018, the share of Treasury Bills (BOTs)[23] further decreased from 5.59 percent at the end of 2017 to 5.48 percent at the end of December 2018. The CTZs' share[24] increased, moving from 2.13 percent to 2.33 percent over the same period, while the stock of fixed-rate BTPs[25] moved slightly higher, from 71.78 to 71.89 percent.

Despite the turbulence experienced since May 2018, the share of bonds with maturity equal or longer than 10 years issued during the 2018 was around 19.3 percent, vis-à-vis a share of 21.9 percent in 2017, reflecting lower redemptions to be refinanced during the year.

The funding activity in 2018 kept refinancing risk virtually unchanged: the average life of the total stock of government securities at the end of December was 6.78 years compared to 6.90 years in 2017, while the share of securities[26] maturing in one year moved from 15.12 percent to 15.72 percent as of December 2018. In the same period, the share of paper coming due in 5 years reached 53.99 percent, while it was 52.13 at the end of 2017.

During the first quarter of 2019, however, the average life of government securities rose again. Bonds with maturity equal or longer than 10 years accounted for 28 percent of total issuance, marking a record high in the duration brought to the market by Italy in such a short time. In fact, two new benchmark bonds were launched at the long end (15 years and 30 years) via extremely successful syndicated transactions, marking a record both in terms of orders (respectively above 35 and 40 billion orders) and in terms of final size (10 and 8 billion).

In 2018 exposure to interest rate risk was unchanged as well: in 2017 the quota of CCTeus (floaters with a maturity ar issuance of 7 years linked to 6-month Euribor rate) was 6.97 percent and then narrowed to 6.58 as of December 2018. On the other hand, the

---

[23] T-bills, i.e. government paper with a maturity at issuance equal or shorter than 1 year.
[24] CTZ are zero coupon paper with a 2-year maturity at issuance.
[25] BTP are the standard fixed-rate nominal bonds with a maturity range from 3 to 50 years at issuance.
[26] These data include also Postal Bonds.

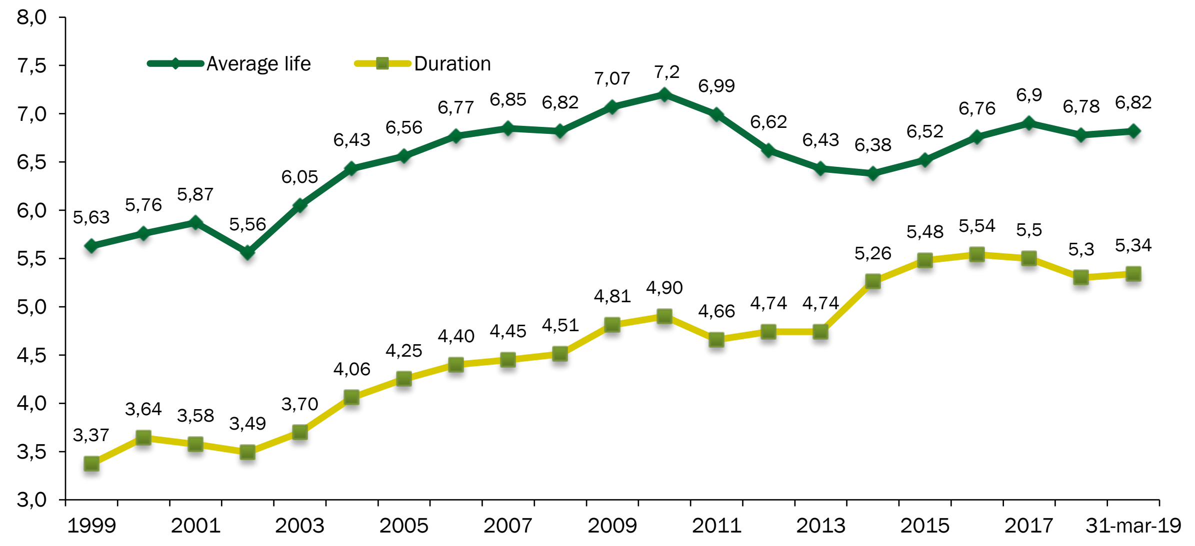
percentage of BTP€I and BTP Italia (inflation-linked bonds linked, respectively, to European and Italian inflation) went from 11.18 at the end of 2017 to 11.62 percent as of December. Consequently, the total share of floating debt (CCTeus, BTP Italia and BTP€i) was pretty much stable at around 18.19 percent, compared with 18.16 percent at the end of 2017.

The *Average Refixing Period (ARP)*[27] marginally declined, from 6.25 as of the end of 2017 to 6.18 years as of March 2019, and so did the duration of total stock of government securities that was 5.83 years of end March 2019 compared to 6.01 as of end 2017.

The stable and relatively lower sensitivity of total debt interest burden to market shocks is the natural outcome of a consistently prudent debt management strategy. This is confirmed by the fact that a permanent shock of 100 basis points on the whole yield curve would impact the interest debt burden for just 0.12 percent of GDP in the first year, 0.27 in the second year, 0.39 in the third year, in line with the estimates published in the in the Stability Program 2019.

Finally, the exposure to exchange rate risk in 2018 remained negligible compared to 2017: at the end of December the share of debt issued in foreign currency unhedged[28] was 0.11 percent, unchanged with respect to the end of 2017.

FIGURE VI.1: AVERAGE LIFE AND FINANCIAL DURATION OF GOVERNMENT SECURITIES OUTSTANDING



Source: MEF

As already pointed out, since May 2018 interest rates on Italian debt increased significantly before moving down again in late December and in the first quarter of 2019. On average, comparing the levels as of mid May and those as of end of December 2018 the

[27] The average refixing period (ARP) reflects the average time still to elapse (without discounting the flows) before the debt structure incorporates the new market rates. For nominal fixed-rate securities, the indicator is based on the residual life of each security, whereas for variable-rate securities and linkers , the indicator is based on the time to elapse until the indexing of the next coupon. Each security is included in the weighted calculation for the nominal value outstanding. Data also include Postal Bonds.

[28] Large part of debt issued in foreign currency is indeed swapped back into euro.

upward shift has been of around 80 basis points while the spread over German government bonds moved up from 130 basis points to around 250 basis points on the 10 year maturity.

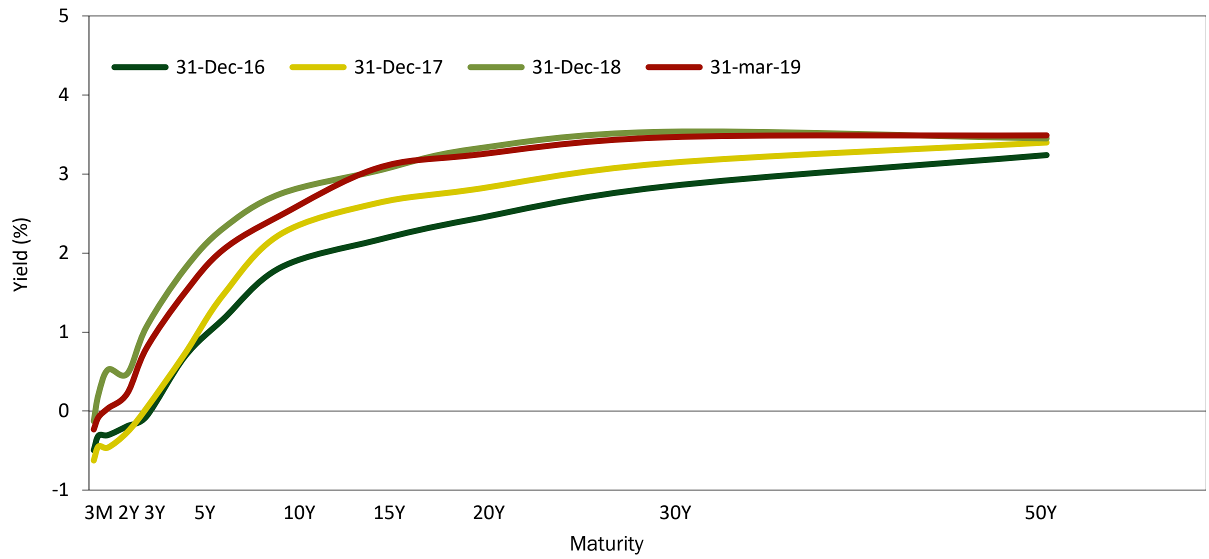
The front end of the curve, initially impacted by the increased volatility following the turmoil started in May 2018, was anchored thereafter, with a re-steepening that at the end of December showed the 1-10 year slope in line with the medium term average.

Conversely, the slope of the 10-30 year segment initially decreased significantly (from 120 to 79 basis points), showing persistent interest from investors in long-term Italian government securities, attributable to the liquidity of the secondary market compared to other sovereign bond markets.

Despite periods of rather high volatility in the second half of 2018, the average cost at issuance at the end of December was less than 1.1 percent, a level that is still near the record low registered in the last few years.

By remaining anchored to a debt management policy focused on keeping under control and further improve resilience to market risks, Italy continued to achieve a reduction of the interest burden, which has been declining since 2012.

FIGURE VI.2: EVOLUTION OF ITALIAN DEBT YIELD CURVE

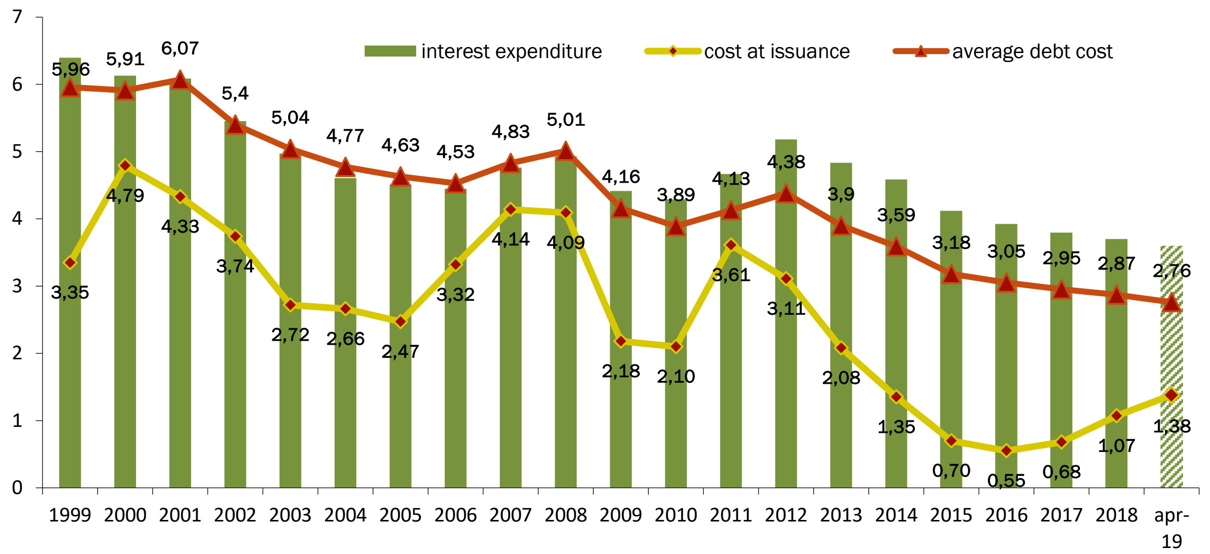


Source: MEF.

Indeed, the average cost on general government debt in 2018 was 2.87 percent, which still marked a reduction vis-à-vis the 2017 level (2.95 percent). Issuance activity in 2018 was only slightly skewed towards shorter maturities, so the marginal cost at issuance has been lower, also driving down the average cost. This trend is continuing in the current year, so that at the end of April 2019 the average debt cost for the year is estimated to hover around 2.76 percent is spite of sizable issuance at the very long end of the curve.

In the first quarter of 2019, thanks to a positive tone of the market following the agreement with the European Commision concerning the 2019 Budget, the sovereign yield curve shifted down and the ten-year BTP-Bund spread tightened from 322 to 250 basis points. During the months of April and May, due to weak economic data for the fourth quarter of 2018 and political noise ahead of the European elections, some volatility returned to the market and the spread moved up to 270-280 basis points.

FIGURE VI.3: EVOLUTION OF THE AVERAGE DEBT COST, COST-AT-ISSUANCE AND INTEREST EXPENDITURE OVER GDP



Source: MEF. For 2019, provisional data for average debt cost and interest expenditure (DEF 2019)

VI.2 FURTHER FEATURES OF PUBLIC DEBT ON A COMPARATIVE BASIS

Both the level and the changes in the share of short-term public debt (in percent of the total debt) provide an indication of increased/decreased refinancing risk (or roll-over risk) and vulnerability in relation to government's reliance on temporary market financing. In the European Commission's approach, those values would be examined in relation to a set of calculated critical thresholds of fiscal risks, according to the so-called signals' approach, so as to establish whether fiscal risks related to the structure of public debt financing may eventually emerge.

According to the Commission methodology for assessing debt sustainability, short-term debt above 6.6 percent may be considered at high risk of rollover whereas its yearly change should be considered highly risky if it recorded an increase above the threshold of 2.76 percentage points. On the basis of Eurostat figures, between 2015 and 2016 the share of short-term debt of Italy decreased from 14 to 13 percent. In 2017, according to the provisional data published by the Bank of Italy[29], the share moved further down by approximately 0.2 percentage points. Accordingly, given the constant reduction pattern, possible risks of roll-over may only stem from the initial share.

Another index which may provide information on the extent to which the government may need to tap the bond market in the current and in future years is represented by the Gross Financing Needs (GFN). The European Commission 2017 Debt Sustainability Monitor presents projections of the GFN up till 2028. In these estimates, Italy appears as having the largest GFN in the EU, amounting in 2017 to 24.4 percent of GDP (1.5 percentage points

[29] Supplemento al Bollettino Statistico – Finanza pubblica, fabbisogno e debito del 15 Ottobre 2018. Tavola 8.

less than reported in 2016). However, such measure appears to be somewhat overestimated as, for instance, the recent IMF Fiscal Monitor[30] reports for Italy a GFN for 2018 of 22.2 percent of GDP, in line with the 21.1 G7 average.

As shown in the previous section, Italy's public debt presents a high average term to maturity (average life) of 6.8 years (increased from the 6.76 of 2016) that compares favorably with those of other developed countries. In particular, according to the IMF, in 2018 the debt-to-average maturity (i.e. an indication of the amount of new issued bonds) will be 19.3 percent of GDP, only marginally higher than the average for G7 countries (Table VI.1).

TABLE VI.1: STRUCTURAL INDICATORS FOR THE DEBT IN 2018

Country	Average term to maturity, 2018	Debt-to-average maturity, 2018
AT	8.3	8.9
BE	9.4	10.8
DE	5.8	10.3
ES	7.0	13.9
FI	6.2	9.8
FR	7.4	13.1
IT*	**6.8**	**19.3**
NL	6.9	7.7
PT	6.2	19.4
SI	8.5	8.2
SW	4.7	8.1
UK	14.9	5.9
USA	5.8	18.3
JPN	7.7	31.1
AUS	7.4	5.5
CAN	5.4	16.1
G-7	6.9	17.9
G20 ADV.	6.9	17.1

Source: IMF Fiscal monitor – October 2018.
(*) Figures provided by national authorities.

VI.3 DEBT SUSTAINABILITY ANALYSIS

The Government strongly believes that Italy's sovereign debt is sustainable and that fiscal consolidation is the only avenue to gradually bring the debt ratio towards the Euro area average and, on a longer view, the Treaty reference value. As we recalled in chapter III, the SP2019 targets a reduction in the public debt-to-GDP ratio from a projected peak of 132.6 percent this year to 128.9 percent in 2022. A whole chapter of SP2019 (Ch.IV, pages 81-114) is devoted to stochastic simulations and debt sustainability analysis (DSA), consistent with the approach of the European Commission

In order to provide a short-term sensitivity analysis of the performance of the debt-to-GDP ratio, we carried out stochastic simulations (see figure below) to capture uncertainty

[30] IMF, 2018, Fiscal Monitor: Managing Public Wealth, October 2018, available at: https://www.imf.org/en/Publications/FM/Issues/2018/10/04/fiscal-monitor-october-2018

about yield levels and real GDP growth[31]. In the event of temporary shocks, the debt ratio is distributed around a median value of approximately 129 percent of GDP in 2022. The uncertainty at the end of the period is relatively limited, (there is a difference of 15.4 pps between the tenth and ninetieth percentiles of the distribution). Permanent shocks lead to a wider distribution of debt-to-GDP ratios around the central scenario (between the tenth and ninetieth percentiles of the distribution there is a difference of 17 pps), but the first sixty percentiles mimic the dynamic obtained under temporary shocks.

FIGURE VI.4: STOCHASTIC PROJECTION OF THE DEBT-TO-GDP RATIO WITH TEMPORARY SHOCKS

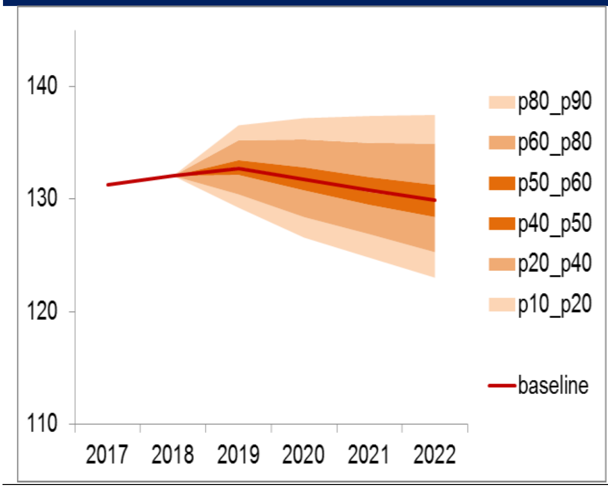
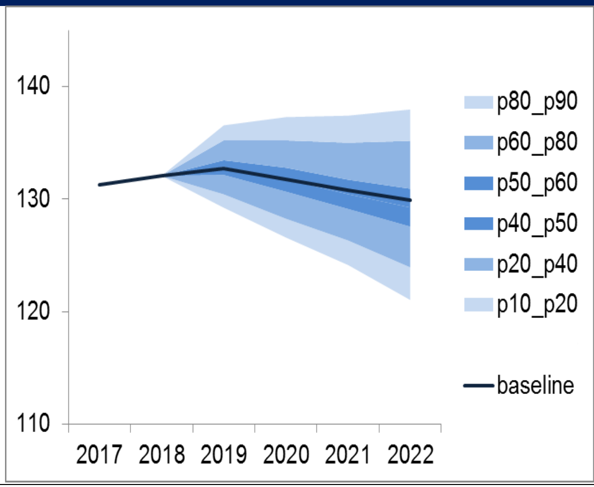


FIGURE VI.5: STOCHASTIC PROJECTION OF THE DEBT-TO-GDP RATIO WITH PERMANENT SHOCKS



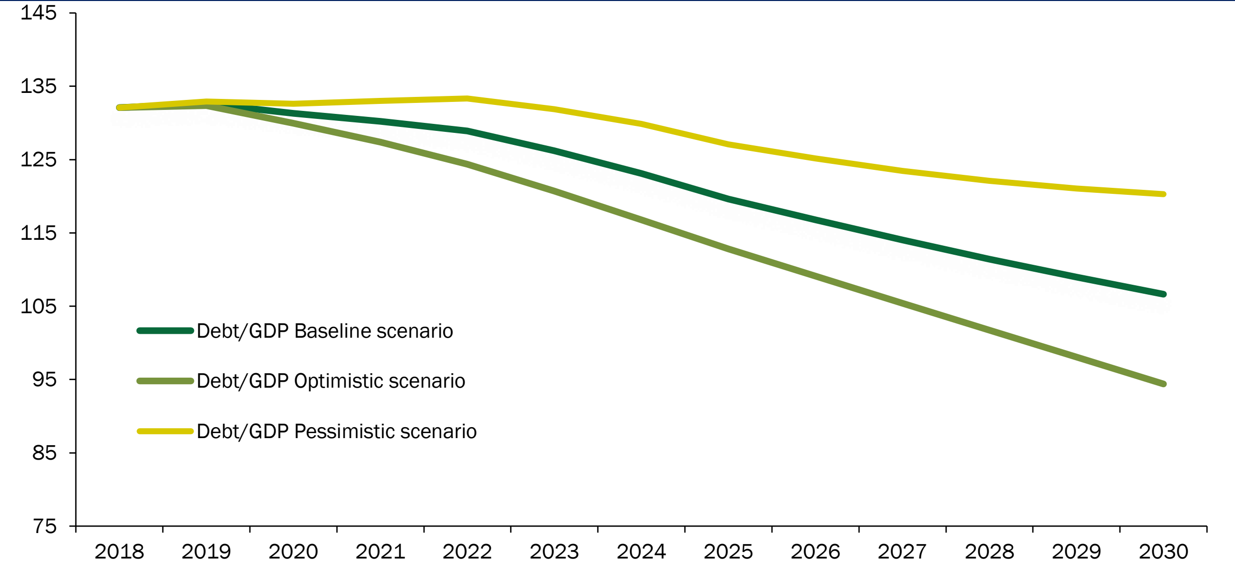
Note: The graphs illustrate the tenth, twentieth, fortieth, fiftieth, sixtieth, eightieth and ninetieth percentiles of the distribution of the debt-to-GDP ratio obtained with the stochastic simulation.
Source: MEF analysis.

Moving to the analysis to the medium term (ten-year) horizon within a DSA framework, the decreasing tendency of the debt-to-GDP ratio is confirmed[32]. The baseline scenario prolongs the public sector debt projections of the policy scenario of SP2019 all the way out to 2030. The simulations show a sustained decrease in the debt to GDP ratio, which becomes even faster under the alternative positive scenario. In the negative scenario, the ratio is projected to decrease slightly in the first years of the forecast horizon and then more steeply until the end of the forecast horizon 2030.

[31] The simulations were carried out using the Montecarlo method, applying shocks to interest rates and nominal growth to the dynamics of the debt-to-GDP ratio relative to the policy scenario. Shocks are based on the historical volatility of returns (short and long term) and nominal GDP growth rate, and are obtained by executing 2000 extractions from a normal distribution with zero mean and variance-covariance matrix observed in the 1999-2017 period. Two cases are analysed: in the first one, the shocks to interest rates are transitory, in the second they are permanent. Shocks on nominal growth are assumed to be temporary but they also affect the cyclical component of the primary surplus.

[32] The positive scenario assumes that from 2019 onwards the spread versus the ten year German bonds tightens permanently by 100 basis points as a result of a decrease in market volatility and a more balanced perception of risks associated to Italian public finances. Naturally, the spreads on the other maturities, shorter and longer than the 10-year maturity, are parameterized in line with the change observed on the 10-year maturity, taking into account the shape of the forward spread curve between Italian and German bonds. On the other hand, the negative scenario, in addition to a worsening of external conditions, foresees a further upward shift of the yield curve with respect to the baseline in the short term; interest rates on the 10-year maturity are assumed to increase by 100 basis points return to the baseline levels only from 2022

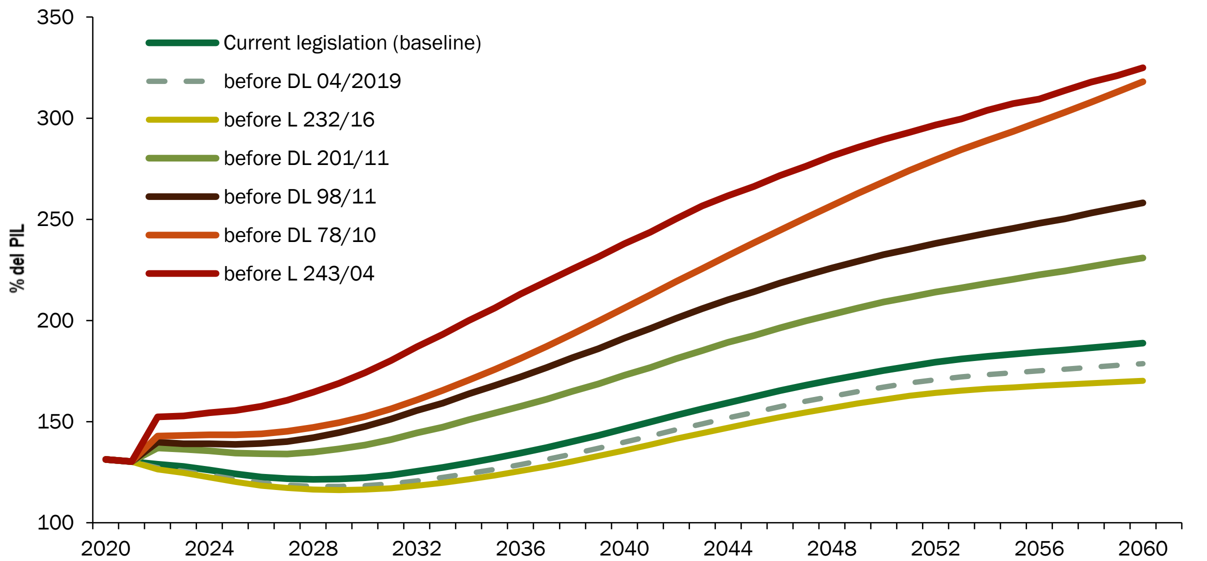
FIGURE VI.6: MEDIUM-TERM FORECAST OF DEBT-TO-GDP RATIO IN HIGH AND LOW GROWTH SCENARIOS



Source: MEF analysis.

Our analysis also includes long-term simulations which hilight a sustainable profile for public debt. The main factors underpinning the simulation results are: i) a sizeable primary surplus, and ii) the expected evolution of ageing-related expenditure. The latter ensures a reduction in pension expenditure and a diminishing impact on welfare expenditure. In fact, the pension system remains a factor of resilience, as acknowledged by the Commission in the 2018 Fiscal Sustainability Report [33].

FIGURE VI.7: IMPACT OF PENSION REFORMS ON DEBT-TO-GDP RATIO (% OF GDP)



Source: MEF analyses through State General Accounting Department long-term forecasting model.

[33] The S2 indicator as estimated by the Commission confirms that the Italian debt is one of the more sustainable over the long term among the EU countries. The gap relative to the primary balance required to stabilize debt at the current level and pre-finance all future increases in age related expenditures is positive (3.1 percent of GDP according to the Commission vs 0.2 per cent for Government according to the 2019 PS data). However, using the national scenario the value of S2 turn negative (-0.6 pps of GDP)

Demographic trends (decreasing birth rate and rising life expectancy) pose a challenge to debt sustainability. However, the demographic projections underlying the 2018 Ageing Report look quite pessimistic with respect to the fertility rate and net migration flows. National authorities hold a less pessimistic view also with respect to other assumptions that drive long-term expenditure trends, namely total factor productivity trends and the starting level of the structural balance. Based on those assumptions, the long-term Italian fiscal position looks even more sustainable.

VI.4 CONTINGENT LIABILITIES

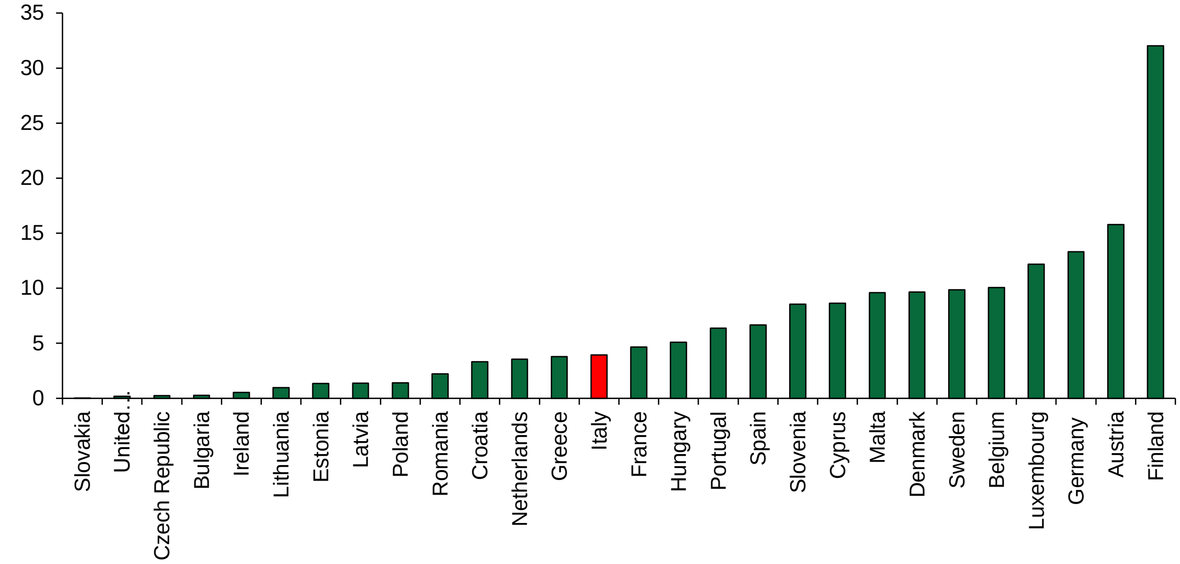
According to the January 2019 Eurostat release on contingent liabilities and non performing loans in the EU Member States, in a comparison with main European partners, Italy presents one of the lowest stocks of guarantees on liabilities at 3.9 percent of GDP in 2017. In 2018, Italy's stock has slightly increased compared to 2017 at 4.2 percent of GDP, due to guarantees in favor of the financial sector (including GACS and in favour of Cassa Depositi e Prestiti) and SACE. The guarantees related to the financial sector declined since 2012, thanks to lower guarantees issued in favour of the banking system (approximately 1.2 percent of GDP in 2018 against a high of 5.3 percent in 2012). More recently, the government has been issuing guarantees on senior tranches of securitizations of NPLs (GACS). The amounts involved do not change the overall picture, as they are small as a share of GDP.

Moreover, the potential risk stemming from the Italian government's participation in corporations' capital are in line with the major economies of the European Union and significantly below the figures of other countries with a lower level of public debt, such as Germany and the Netherlands, whose liabilities of government controlled entities classified outside general government represent respectively 91.7 and 102.7 percent of GDP.

As explained in the Eurostat release, when comparing these data across countries it should be noted that: i) the main reason for the high level of these liabilities is that the data include government controlled financial institutions, among other public banks; ii) most of these liabilities consist of deposits held in these public banks by households or by other kinds of private or public entities; iii) financial institutions report high amounts of debt liabilities, however they also have, at the same time, significant level of assets which are not captured by the data.

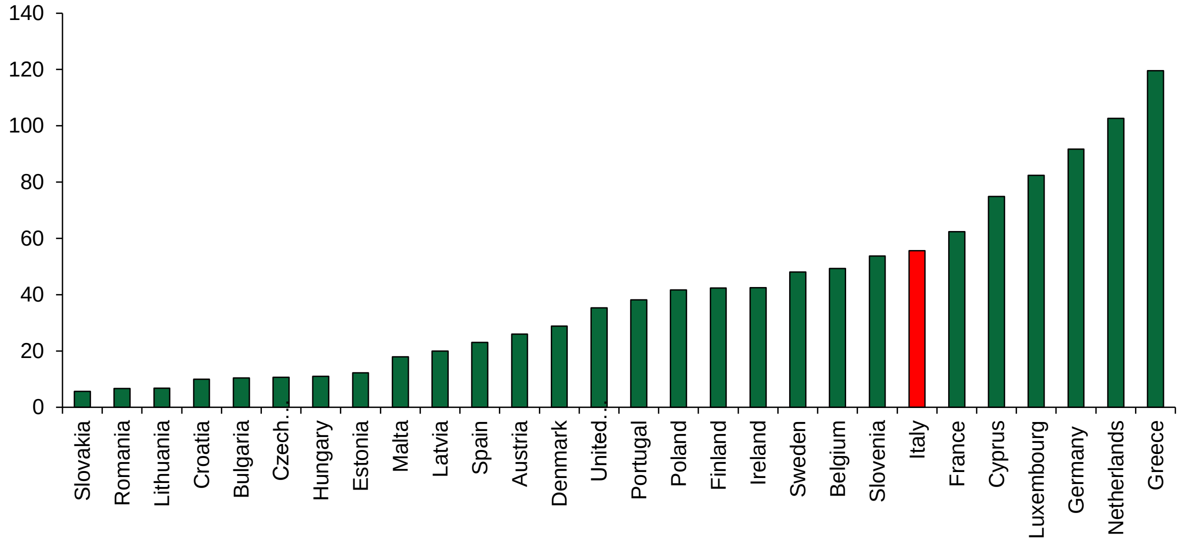
Finally, unlike most other Member States, Italy has the one of the lowest stock of non-performing loans (asset) of the general government, whose amount is stable at 0.01 percent of GDP since 2012. For many European countries showing the highest stock of NPLs, the majority of these loans refer to loans of financial defeasance structures, which are classified in the general government sector.

FIGURE VI.8: TOTAL STOCK OF GOVERNMENT GUARANTEES IN 2017 (% of GDP)



Source: Eurostat.

FIGURE VI.9: TOTAL LIABILITIES OF GOVERNMENT CONTROLLED ENTTIES IN 2017 (% of GDP)

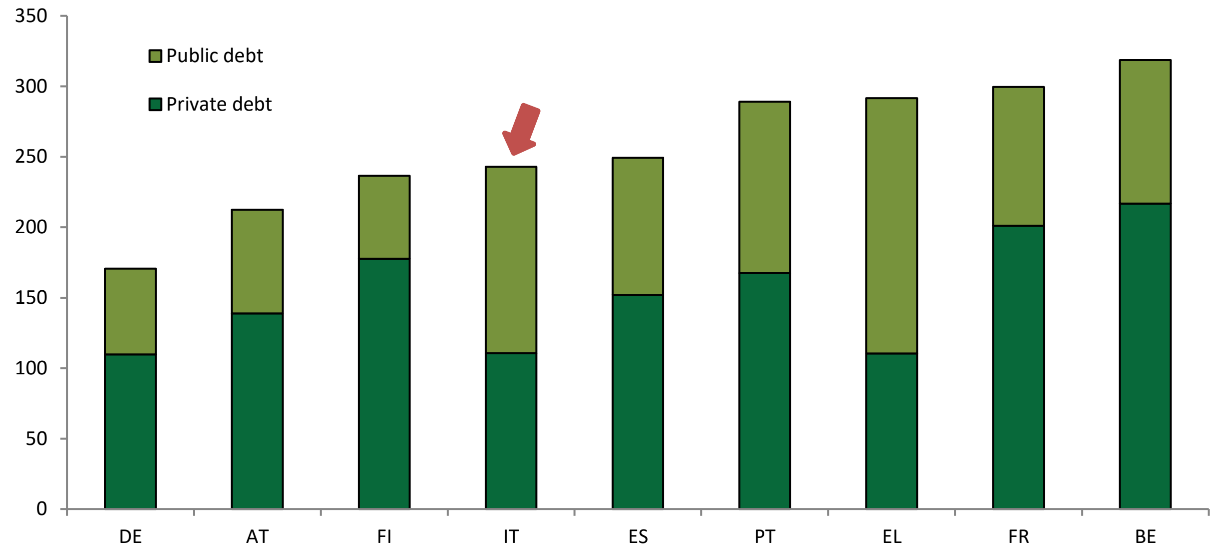


Source: Eurostat.. For Austria, Czech Republic, France and Germany 2016 data.

VI.5 PRIVATE SECTOR DEBT

Firms' and households' financial conditions slightly improved in 2018. According to latest ECB data, reported by Bank of Italy[34], the debt-to-GDP ratio (that takes into account loans and securities for both households and non-financial companies) of Italy's private sector remains one of the lowest in the Euro-area and is equal to 110.7 percent. The Italian household sector remains one of the less indebted with a debt corresponding to 41.1 percent, while the ratio of firms' financial debt-to-GDP in 2018 amounts to 69.6 percent.

FIGURE VI.10: PUBLIC AND PRIVATE DEBT DECOMPOSITION (% of GDP, 2018)



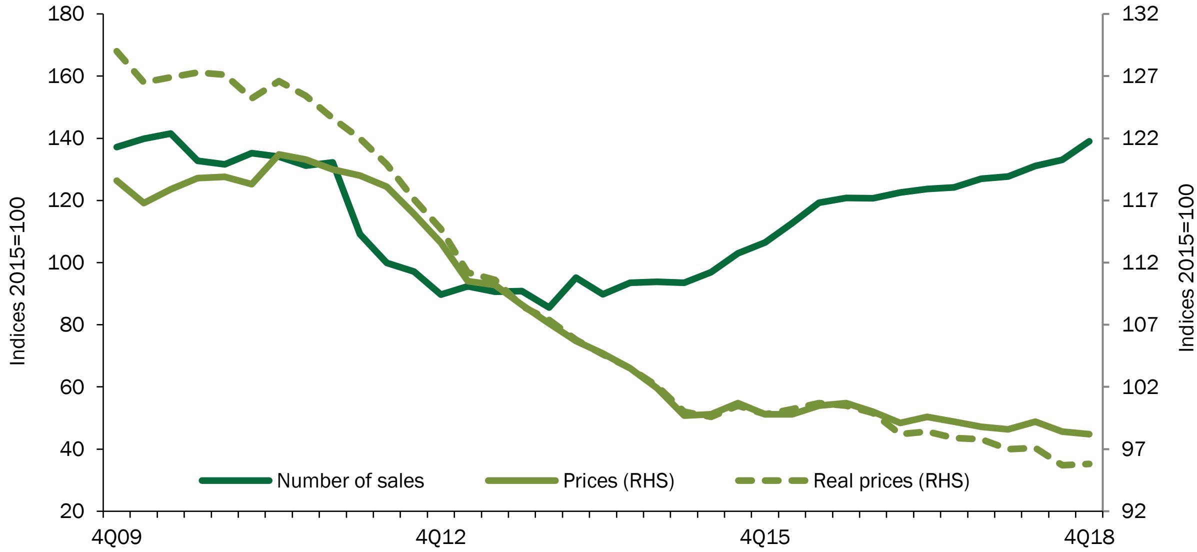
Source: Eurostat and Bank of Italy. Private debt includes loans and securities..

VI.6 PROPERTY PRICES

As far as the property sector is concerned, the number of sales is rising but prices for both residential and non-residential properties continue to decrease, especially in real terms[35]. However, expectations of the real estate agents interviewed for the Italian Housing Market Survey[36] remain moderately positive about overall market conditions, although consistent with a softness in short-term prices. The survey reveals that there is no clear upward pressure on house prices and confirms a significant difference between selling and asking prices as one of the main causes of listings not being renewed.

[34] See: Bank of Italy, Financial Stability Report 1/2019, May 2019.
[35] According to latest estimates by Bank of Italy, house prices are expected to decline, albeit slightly, in 2019 as well. See: Bank of Italy, Financial Stability Report 1/2019, May 2019.
[36] See: Bank of Italy, Italian Housing Market Survey 2019 Q1.

FIGURE VI.11: RESIDENTIAL PROPERTY

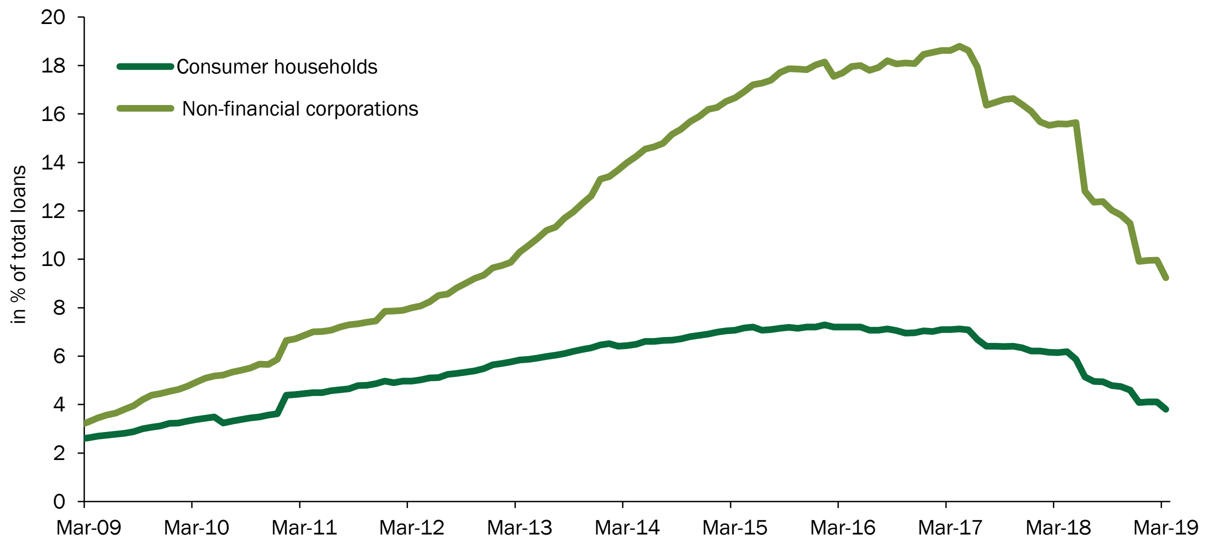


Source: Bank of Italy

VI.7 BANKS' CAPITAL RATIOS AND NPLS

Italian banks' capital ratios continue to improve. At the end of 2018, the ratio between common equity tier 1 and risk-weighted assets (CET1 ratio) of Italian banks amounted to 13.3 percent, an increase of 10 basis points compared with June. The improvement was mainly related to the less significant banks, whose CET1 ratio rose by about 30 basis points reaching 16.5 percent. This improvement was partly on account of the reduction in risk-weighted assets following the decline in NPLs[37]. The capital ratios for significant groups remained stable at 12.7 percent.

FIGURE VI.12: NON-PERFORMING LOANS (IN % OF TOTAL LOANS)

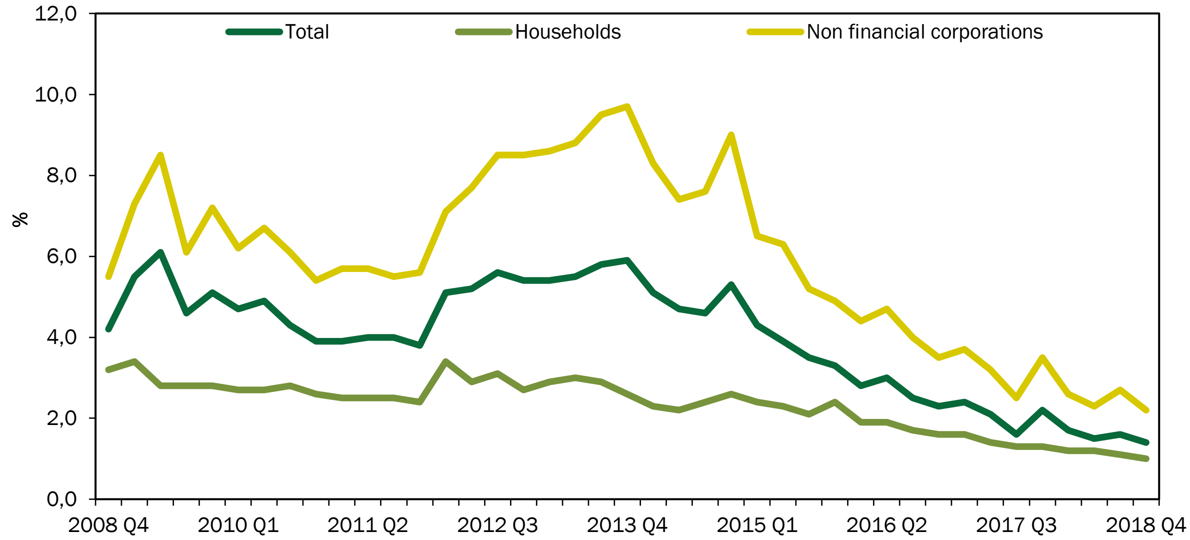


Source: Bank of Italy.

[37] See: Bank of Italy, Banks and Money: National Data - March 2019, May 2019.

In the fourth quarter of 2018, the flow of new non-performing loans in proportion to total performing loans fell by 0.2 percentage points to 1.4 percent. The decline was mostly associated with loans to firms, for which the rate of deterioration declined from 2.7 to 2.2 percent, while the indicator for households remained stable at around 1 percent. Since 2015 growth in bank lending has been concentrated in firms that are less risky; as a result, the cyclical slowdown may have a lower effect on credit quality.

FIGURE VI.13: NEW NON-PERFORMING LOAN RATE



Source: Bank of Italy.